TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1934

No. 176

WILLIAM E. HERRING, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE.

No. 177

EULA DAY HERRING, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

PETITION FOR CERTIORARI FILED JULY 14, 1934.

CERTIORARI GRANTED OCTOBER 8, 1934

SUPREME COURT OF THE UNITED STATES

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JOINT STIPULATION AND ORDER TO PRINT THE RECORD IN THE CASE No. 7214, AND TO OMIT THE PRINTING OF THE RECORD IN CASE No. 7215, ETC.

Filed November 8, 1933.

UNITED STATES CIRCUIT COURT OF APPEALS
FIFTH CIRCUIT.

WILLIAM E. HERRING,

Petitioner,

versus No. 7214

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

EULA DAY HERRING,

Petitioner,

versus No. 7215

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

It is ordered that the record in case No. 7214, William E. Herring, petitioner, vs. Commissioner of Internal Revenue, respondent, be printed, but that the printing of the record in case No. 7215, Eula Day Herring, petitioner, vs. Commissioner of Internal Revenue, respondent, be omitted; that a like judgment be entered in case No. 7215, Eula Day Herring, petitioner, vs. Commissioner of Internal Revenue, respondent, as in case No. 7214, William E. Herring, petitioner, vs. Commissioner of Internal Revenue, respondent.

N. P. BRYAN,
U. S. Circuit Judge.

Nov. 8, 1933.

1a

STIPULATION.

United States Circuit Court of Appeals for the Fifth Circuit.

Eula Day Herring, Petitioner,

v. Docket No. 7215

Commissioner of Internal Revenue, Respondent.

Whereas the issues in the above entitled cause are precisely the same as the issues in the action entitled William E. Herring v. Commissioner of Internal Revenue, and as the proceedings were consolidated, heard, and disposed of before the United States Board of Tax Appeals on one record, and as the transcript of record on the petitions for review are the same, except as to names, no useful purpose could be served by hearing the cases separately before this Honorable Court.

It is therefore stipulated and agreed by and between the parties in the above entitled cause, through their respective attorneys, that the printing of the transcript record in this cause may be dispensed with and that the decision of the Court in the case of William E. Herring v. Commissioner of Internal Revenue will control and will be accepted by the parties as the decision in the above entitled case.

ROBERT ASH,
Attorney for Petitioner.
E. BARRETT PRETTYMAN,
General Counsel, Bureau of Internal Revenue.

1t DOCKET No. 47041.

William E. Herring, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.

Appearances:
For Petitioner: Robert Ash, Esq., T. J. Reilly, Esq.
For Respondent: F. B. Schlosser, Esq., E. G. Sievers, Esq.

Docket Entries.

Transferred to Mr. Goodrich, 5/11/33.

1930
Jan. 17—Petition received and filed. Taxpayer notified. (Fee paid.)
Jan. 18—Copy of petition served on General Counsel.
Feb. 24—Notice of appearance of Robert Ash and T. J. Reilly as counsel for taxpayer filed.
Feb. 27—Answer filed by General Counsel.
Mar. 10—Copy served on taxpayer—General Calendar.
1931
Jan. 31—Motion to consolidate with docket 47042 filed by taxpayer. 2/3/31 granted.
Jan. 31—Motion to place on Texas Circuit Calendar filed by taxpayer. 2/3/31 granted.
1932
Feb. 4—Hearing set Apr. 6, 1932.
Feb. 9—Notice to disregard notice of hearing for April 6, 1932—case to remain on Circuit Calendar.
Oct. 28—Notice of hearing at Dallas, Texas, beginning Nov. 28, 1932.

Dec. 9—Hearing had before Mr. Lansdon, Division 8. Submitted on merits. Called from calendar of Nov. 28, 1932. Stipulation of facts filed. Briefs due Feb. 8, 1933.

1933

Jan. 9—Transcript of hearing 12/9/32 filed.

Feb. 2—Motion for extension to March 1, 1933 to file brief filed by taxpayer. 2/2/33 granted to 3/1/33 to both parties.

Mar. 4—Motion for extension to Feb. 15, 1933 to file brief filed by General Counsel.

Mar. 1—Brief filed by taxpayer.

Mar. 1—Brief filed by General Counsel.

June 29—Memorandum opinion rendered—Edgar J. Goodrich, Division 11. Judgment will be entered for the respondent.

July 5—Decision entered—Edgar J. Goodrich, Division 11.

Sept. 28—Petition for review by U. S. Circuit Court of Appeals, 5th Circuit, with assignments of error filed by taxpayer.

Sept. 28—Proof of service filed by taxpayer.

Sept. 28—Praecipe filed by taxpayer.

Sept. 28—Proof of service filed.

1933

2 Oct. 10—Agreed statement of evidence lodged.

Oct. 11—Stipulation re exhibits filed.

Oct. 11—Agreed statement of evidence approved and ordered filed.

Oct. 11—Order that original exhibits, petitioner's Nos. 2, 3 and 4, be transmitted to U. S. Circuit Court of Appeals, 5th Circuit, said exhibits to be returned to Board after they have served their purpose, entered.

3

PETITION.

Filed Jan. 17, 1930.

U. S. Board of Tax Appeals.

United States Board of Tax Appeals.

William E. Herring, Petitioner,
vs. Docket No. 47041
Commissioner of Internal Revenue, Respondent.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:AR:B-8-AMK-60D) dated November 26, 1929, and as a basis of this proceeding alleges as follows:

1. The petitioner is an individual residing at 411 Polk Street, Amarillo, Texas. Petitioner is the husband of Eula Day Herring and for the year 1926 filed his income tax return on a community property basis.

2. The notice of deficiency, a copy of which is attached and made a part of this petition, is dated November 26, 1929. The petitioner has no knowledge as to the date it was mailed.

3. The taxes in controversy are income taxes for the calendar year 1926 in the amount of $11,337.29.

4

4. The determination of tax set forth in the said notice of deficiency is based upon the following error:

(a) The Commissioner erred in refusing to allow a depletion deduction in the amount of $188,043.28 to the partnership of C. T. Herring & Son, of which petitioner has a one-half interest.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) C. T. Herring and the petitioner were equal partners in C. T. Herring & Son. The said partnership owned certain land in Texas, on all sides of which were producing oil and gas wells. In 1926 the Gulf Production Company, Roxana Petroleum Corporation, Magnolia Petroleum Company, Marland Oil Company, The Texas Company, and other large producers of oil and gas entered into certain leases or contracts with the said partnership whereby the partnership granted and conveyed to the said oil and gas producers the right to explore for and extract oil and gas from certain of the land owned by the partnership. In consideration of executing the said leases or contracts the partnership received $683,793.75 during the year 1926. In reporting the tax liability on the said $683,793.75 the partnership deducted $188,043.28 as depletion in accordance with the provisions of Section 204(c) of the Revenue Act of 1926 which provides:

"The basis upon which depletion, exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the same as is provided in sub-divisions (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * * *

"(2) In the case of oil and gas wells, the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) on the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

The respondent disallowed the said deduction.

Wherefore, the petitioner prays that this Board may hear the proceeding and

(a) Determine the proper method of taxing the $683,793.75 received by the partnership of C. T. Herring & Son in consideration of executing oil and gas leases on land owned by the partnership.

(b) Grant such other and further relief as the Board may deem proper.

ROBERT ASH,
THOMAS J. REILLY,
Attorneys for Petitioner,
Munsey Building, Washington, D. C.
PARFET & MARTLEW,
Wichita Falls, Texas,
Of Counsel.

6 State of Texas,
County of Potter, ss:

William E. Herring, being duly sworn, says that he is the petitioner named in the foregoing petition, that he has read the foregoing petition or had the same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

WILLIAM E. HERRING.

Subscribed and sworn to before me this 10th day of January, 1930.

JOHN O. FAIN,
(Seal) Notary Public.

7 Treasury Department,
Washington.

IT:AR:B-8
AMK-60D

Nov. 26, 1929.

Mr. William E. Herring,
411 Polk Street,
Amarillo, Texas.

Sir:

In accordance with Section 274 of the Revenue Act of 1926, you are advised that the determination of your tax liability for the year 1926 discloses a deficiency of $11,337.29, as shown in the statement attached.

The section of the law above mentioned allows you to petition the United States Board of Tax Appeals within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter for a redetermination of your tax liability.

However, if you do not desire to petition, you are raquested to execute the inclosed Form 866 and forward both original and duplicate to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement form will expedite the closing of your return by permitting an early assessment of any deficiencies and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the agreement form, or on the date assessment is made, whichever is earlier; whereas if no agreement is filed, interest will accumulate to the date of assessment of the deficiencies.

Respectfully,
ROBT. H. LUCAS,
Commissioner,

By .....
Deputy Commissioner.

Inclosures:
Statement.
Form 866.
Form 882.
BAS-1

8 Statement.

IT:AR:B-8
AMK-60D

Nov. 26, 1929.

In re: Mr. William E. Herring,
411 Polk Street,
Amarillo, Texas.

Tax Liability.

Year	Corrected Tax Liability	Tax Previously Assessed	Deficiency
1926	$25,924.55	$14,587.26	$11,337.29

Further reference is made to the report of the Internal Revenue Agent in Charge at Dallas, Texas, covering the years 1923 to 1926, inclusive.

The years 1923, 1924 and 1925 have been closed on the basis set forth in office letter to you dated August 27, 1929, to which you have agreed.

You protested the disallowance of depletion to the partnership of C. T. Herring and Son amounting to $188,043.28 for the year 1926 and have indicated a desire to appeal this issue to the United States Board of Tax Appeals.

The depletion was disallowed in accordance with Income Tax Ruling 2361, Cumulative Bulletin VI-1, Page 73, for the reason that the property upon which depletion was claimed was neither proven nor producing during the year in question.

Net income reported	$187,190.66
Add:	
1. Partnership income	88,533.56
2. Rental income	1,677.16

3. Loss on sale of three houses overstated	650.00
4. Loss on the sale of three houses transferred	700.00
Net income adjusted	$278,751.38

9 Mr. William E. Herring. Statement.

One-half, community income	$139,375.69
Less:	
Exemption	1,750.00
Income subject to normal tax	$137,625.69

Computation of Tax.

Normal tax:		
1½% on $4,000.00		$ 60.00
3% on $4,000.00		120.00
5% on $129,625.69		6,481.28
Surtax on $139,375.69		19,535.14
Total tax		$ 26,196.42
Less:		
Earned income credit	$228.12	
Credit of 12½% of $350.00 (one-half of $700.00)	43.75	
		271.87
Net tax liability		$ 25,924.55
Tax previously assessed		14,587.36
Deficiency in tax		$ 11,337.29

Explanation of Items Changed.

1. Income from partnership of C. T. Herring and Son adjusted to agree with agent's report.

2. See Schedule 1-A, Item 5 of agent's report.

3. Loss on the sale of three houses sold off the lots upon which they were located overstated by $650.00.

4. Since these houses were held for more than two years, you have been allowed a credit of 12½% of $350.00, one-half of the corrected loss of $700.00, against the total tax liability in accordance with Article 1654 of Regulations 69.

Payment should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

10 Mr. William E. Herring. Statement.

A copy of this communication has been transmitted to your representative, Mr. Thomas J. Reilly, Munsey Building, Washington, D. C., who has on file in this office a duly recorded power of attorney.
FB-2

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11 ANSWER.

Filed Feb. 27, 1930.

(Title Omitted.)

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of In-

ternal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

(1) Admits the allegations contained in paragraph 1 of the petition.

(2) Admits that the notice of deficiency, a copy of which is attached and made a part of the petition, is dated November 26, 1929, and avers that the said notice of deficiency was mailed to the petitioner on November 26, 1929.

(3) Admits the allegations contained in paragraph 3 of the petition.

(4) Denies the respondent erred in the determination of the deficiency as alleged in paragraph 4(a) of the petition.

(5) Admits that C. T. Herring and the petitioner were equal partners in C. T. Herring and Son; that the said partnership of C. T. Herring and Son deducted in its return for the year 1926 the sum of $186,043.28 as depletion, which amount was disallowed by the respondent. Denies all further allegations of fact contained in paragraph 5 of the petition.

Denies generally and specifically each and every allegation of the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the appeal be denied.

(Signed) C. M. CHAREST,
General Counsel, Bureau of
Internal Revenue.

Of Counsel:

MAXWELL E. McDOWELL,
FRANK B. SCHLOSSER,
Special Attorneys, Bureau of
Internal Revenue.

12 MEMORANDUM OPINION.

William E. Herring, Petitioner,
v.
Commissioner of Internal Revenue, Respondent.

Mrs. Eula Day Herring, Petitioner,
v.
Commissioner of Internal Revenue, Respondent.

Docket Nos. 47041,
47042.

Robert Ash, Esq., for the petitioner.
F. B. Schlosser, Esq., and E. G. Sievers, Esq., for the respondent.

GOODRICH: In these proceedings, which were consolidated for hearing, petitioners assail respondent's determinations of deficiencies in income tax for the year 1926 against each of them in the amount of $11,337.29. Petitioners are husband and wife, residents of Texas, and filed separate returns under the Texas community property laws. They hold an interest in the partnership of C. T. Herring & Son, which was engaged in the cattle business, and owned several ranches in the vicinity of Amarillo. During 1926 the partnership granted a number of oil and gas leases to
13 various individuals and corporations and received as bonuses therefor a total of $683,793.75. No oil was produced from the properties during the taxable year; indeed, there was no production until 1930. The partnership, on its return for 1926, claimed as a deduction from its income, a depletion allowance of 27½ per centum of the total royalties received. Respondent has disallowed this claim and has restored the proportionate amounts of the sum so deducted to the incomes of the members of the partnership. That

action gives rise to the deficiencies herein, and the sole issue is whether the claim for the depletion allowance as a deduction should be allowed.

This issue is controlled by our decision in the case of Lizzie H. Glide, 27 B. T. A. #129, wherein we held that the allowance of a deduction on account of depletion of oil and gas wells was dependent upon production from the property. Here there was no production during the taxable year before us, nor was there at that time more than a speculative possibility of production.

In view of the cited decision, our conclusion here perforce must be contrary to petitioners' contentions. Cf. Aubrey Umsted et al. 28 B. T. A. #34.

Judgment will be entered for the respondent.

Enter:
Entered: June 29, 1933.

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14 DECISION.

United States Board of Tax Appeals,
Washington.

William E. Herring, Petitioner,
v. Docket No. 47041
Commissioner of Internal Revenue, Respondent.

Pursuant to the determination of the Board, as set forth in its report promulgated memorandum opinion entered June 29, 1933, it is

Ordered and decided: That there is a deficiency of $11,337.29 for the year 1926.

Enter:
Entered July 5, 1933.
(Signed) EDGAR J. GOODRICH,
(Seal) Member.

15 PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS.

Filed Sep. 28, 1933.

(Title Omitted.)

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Fifth Circuit:

William E. Herring in support of this, his petition for the review of the decision of the United States Board of Tax Appeals entered July 5, 1933 approving a deficiency in income taxes for the year 1926 in the amount of $11,337.29 respectfully shows to this Honorable Court as follows:

I.

Statement of the Case.

On January 17, 1930 the petitioner filed with the United States Board of Tax Appeals, in pursuance with the Revenue Act of 1926, his petition requesting the redetermination of a deficiency in income taxes for the calendar year 1926 in the amount of $11,337.29. The petitioner contended that an allowance for depletion should be allowed on account of bonuses received for executing oil and gas leases.

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At the trial before the Honorable William C. Lansdon at Dallas, Texas, December 9, 1932 the following facts were stipulated or proved:

The petitioner and his wife filed separate income tax returns for 1926 under the Texas community property laws. They hold an interest in the partnership of C. T.

Herring and Son, Webster Building, Amarillo, Texas. The partners' respective shares in the partnership for 1926 were as follows:

C. T. Herring, Amarillo, Texas.....50%
William E. Herring, Amarillo, Texas....50%

The partnership's principal business in 1926 was cattle raising. It owns several ranches in the vicinity of Amarillo. During the taxable year, it leased portions of its ranches to various individuals and corporations for the purpose of exploring for and producing oil and gas. For executing the said leases, the partnership received bonuses totaling $683,793.75.

No oil development had been begun on any of the tracts at date of leasing. There was no oil well nearer than three and one-half miles at such date. There was no oil production during the taxable year.

Depletion in the amount of $188,043.28 against the above bonus receipts was claimed in the partnership return for the year 1926. This was at the
17 rate of 27½%. The respondent disallowed the deduction and increased the taxable income of the petitioners by their pro rata part of the deduction, to-wit: $94,021.64.

There was introduced in evidence a map (Pet.'s Ex. 2) showing in color the various leases referred to in the stipulation; a map (Pet.'s Ex. 3) showing the wells drilled on the Herring land and adjacent to it; and a geological contour map (Pet.'s Ex. 4) showing the trend of the Panhandle oil field in a northwesterly direction through Hutchinson County.

In the discovery of an oil pool certain fundamental factors must be present: (1) structural conditions must be favorable to the accumulation of oil, (2) oil must be in the vicinity, and (3) there must be a forced bed to act as a reservoir to hold the oil. In the Texas Panhandle such conditions exist as has been proved by

oil production throughout a territory of about 120 miles, starting at Wheeler County and running in a northwesterly direction through Moore County, including Wheeler, Gray, Carson and Hutchinson Counties. Over this space of approximately 120 miles conditions are generally the same. There is an enormous structural condition, underlaid with granite. The area is flat along the north side of this ridge. The oil accumulates to the north and east of the ridge and has migrated on up the structure until it comes against the granite.

18

The property here involved is in Hutchinson County. The geological condition referred to has resulted in production southeast of the Herring land and along the same direction northwest of the land. Reference to the geological map (Pet.'s Ex. 4) indicates that the Herring property is on the direct line of the favorable geological conditions. That map and Petitioner's Exhibit 3 show the 20,000,000 foot gas well to the north of the property; the numerous wells close to the property on the east, west and south, and the production some distance away to the northwest, all of which followed the general geological trend of the field.

Four wells have been drilled on the Herring property. The first, on the Bason Survey in the northernmost portion, is shown on the map (Pet.'s Ex. 3) as a dry hole, but the testimony shows it was drilled by the Gulf Production Company and made from two to three million feet of gas with a good showing of oil. The well drilled by the Gulf Production Company in Section 5 H. & G. N. Survey, in the southern portion of the tract, made 11,400,00 feet of gas and eight to ten barrels of oil. The Phillips Petroleum Company drilled a well in Section 7 of the H. & O. B. R. R. Co. survey on the east side of the property which produced four and one-half million feet of gas, with a favorable showing of oil. The Magnolia drilled a well, opposite

the Phillips well and a very short distance to
19 the south. The Magnolia well produced five
million feet of gas.

The wells mentioned were all drilled about 1930: the reason that they had not been drilled prior to that time being due to economic conditions. The Herring land was leased in long-term leases. It is the logical land to be drilled as soon as economic conditions improve. Under present conditions Panhandle oil cannot compete with oil produced nearer tidewater, because of cost of shipment and because of its high viscosity and sulphur content.

At the time of the hearing (December, 1932) the gas pipe lines from the Panhandle to Chicago, Omaha, Denver, Fort Worth and Indianapolis had been completed, so the gas wells on the Herring property could be commercially operated very profitably, the gas being worth about 4 cents a thousand cubic feet. At this rate the 23,900,000 feet of gas produced easily by the four wells mentioned above would sell for $956.00 a day with the royalty to the Herrings amounting to $119.50 per day.

The developments since 1926 have not in any way condemned the Herring land for oil production, "in fact, the developments we have there now would give us more information for drilling wells later on; I think it would be easier to locate production on that land than it would be without any wells drilled around there. We have wells practically on every side; we have production here to the east, production to the south
20 of us, production to the west of it and wells
of twenty to forty barrels on the north and northwest of it."

The wells drilled on the Herring land showed the same structural condition as is typical of the Panhandle field. Due to a re-entrant in the Herring land it is particularly well situated from a structural viewpoint, and it is very probable that oil will be found on the land.

It is possible, but not probable, that there might never be oil wells on this Herring land, because there is evidence that there is gas under the whole ranch, and from known indications, it looks very probable that there will be oil there. In the Panhandle the oil is found in pools, some very close together and in some places about seven miles apart, but the gas is continuous throughout the area. Gas and oil are very closely related. In the Panhandle area, but not in other oil pools, the oil is found floating on water at about sea level. Gas, being of lighter specific gravity, is found on top of the oil. The location of gas suggests the probability of finding oil. The Herring land is very favorably located geologically. Conditions as known in 1926 were no different from 1932, except that in 1926 the information was not as complete.

In 1926 the nearest oil production to the Herring land was three and one-half miles, and in 1932 one and one-half miles.

June 29, 1933 the Board of Tax Appeals
21 rendered a memorandum opinion approving the determination of the Commissioner that the petitioner was not entitled to depletion on the bonuses received for executing the oil and gas leases because no oil was produced from the properties in 1926. The said opinion was based on the Board's previous opinion in the case of Lizzie H. Glide 27 B. T. A. (July 5, 1933). The Board entered its decision in accordance with the said opinion.

II.

Designation of Court of Review.

The petitioner, being aggrieved by the said opinion and decision, desires a review thereof in accordance with Section 1002 (a) of the Revenue Act of 1926, by the United States Circuit Court of Appeals for the Fifth Circuit, whereof he is an inhabitant.

III.

Assignments of Error.

The petitioner as a basis for review, makes the following assignments of error:

1. The Board of Tax Appeals erred in holding that the bonuses received for executing oil and gas leases are not subject to an allowance for depletion under Section 204 (c) (2) of the Revenue Act of 1926.

2. The Board of Tax Appeals erred in holding that in 1926 there was not more than a speculative possibility of oil or gas production on the property
22 in question, which holding is not supported by any evidence.

Wherefor the petitioner prays that the decision of the Board of Tax Appeals entered against him be reversed and that the Court grant such other and further relief as the Court may deem meet and proper in the premises.

WM. E. HERRING,
Petitioner,
By ROBERT ASH,
Attorney for Petitioner,
Munsey Building, Washington, D. C.

District of Columbia, ss:

Robert Ash, being duly sworn, states that he is attorney for the petitioner; that he knows the contents of the foregoing petition; that to the best of his knowledge and belief the statements contained therein are true, and that the assignments of error are well taken.

ROBERT ASH.

Subscribed and sworn to before me this 28th day of September, 1933.

(Sgd.) MINNIE BURATTI BURCH,
Notary Public.

23 STATEMENT OF THE EVIDENCE.

Lodged Oct. 10, 1933.

Filed Oct. 11, 1933.

(Title Omitted.)

The above entitled cause came up for hearing before the Honorable W. C. Lansdon, Member of the United States Board of Tax Appeals at Dallas, Texas, on the 9th day of December, 1932, there being present the Petitioner by his counsel, Robert Ash and the Respondent by his counsel, Frank B. Schlosser.

Before the introduction of the testimony counsel agreed there was no dispute as to any figures and that the following stipulation of facts should be received in evidence:

The petitioners are husband and wife and filed separate returns under the Texas community property laws. They hold an interest in the partnership of C. T. Herring and Son, Webster Building, Amarillo, Texas. The partners' respective shares in the partnership for 1926 were as follows:

C. T. Herring, Amarillo, Texas.....50%
William E. Herring, Amarillo, Texas..50%

24 The partnership's principal business in 1926 was cattle raising. It owns several ranches in the vicinity of Amarillo. During the taxable year it leased portions of its ranches to various individuals and corporations for the purpose of exploring for and producing oil and gas. The various lessees and the bonus received by the partnership for each lease are as follows:

Sid Hedgecocke, Amarillo, Texas.....	$ 12,400.00
Elgin Boulware, Amarillo, Texas.....	6,400.00
R. B. Archer, Amarillo, Texas.....	9,200.00
Roxanna Petroleum Co., Amarillo, Texas..	66,864.00

Magnolia Petroleum Co., Amarillo, Texas..	36,067.75
McMann Oil and Gas Co., Amarillo, Texas.	30,040.00
Marland Oil and Gas Co., Amarillo, Texas..	17,808.00
Gulf Production Co., Amarillo, Texas.....	209,328.00
Empire Gas and Fuel Co., Amarillo, Texas.	20,580.00
Delmar Oil Co. and Osage Dev. Co., Amarillo, Texas	6,608.00
C. B. Johnson, Amarillo, Texas.....	5,490.00
J. Ray, Amarillo, Texas.....	8,000.00
J. E. Bryant, Amarillo, Texas.....	8,000.00
C. H. Clark, Amarillo, Texas.....	32,000.00
Midwest Exploration Co., Amarillo, Texas.	40,420.00
J. F. Forbes	6,400.00
Amerada Petroleum Co., Amarillo, Texas..	54,450.00
Texas Co., Amarillo, Texas.....	113,738.00
Total bonuses received, 1926.....	$683,793.75

No oil development had been begun on any of the tracts at date of leasing. There was no oil well nearer than three and one-half miles at such date. There was no oil production during the taxable year.

Depletion in the amount of $188,043.28 against the above bonus receipts was claimed in the partnership return for the year 1926. This was at the rate of 27½%. The respondent disallowed the deduction and increased the taxable income of the petitioners by their pro rata part of the deduction, to-wit: $94,021.64.

There was introduced in evidence, without objection as Petitioner's Exhibit No. 1, a copy of oil and gas lease which it was agreed was typical.

There was introduced in evidence, without objection as Petitioner's Exhibit No. 2, a map showing, in color, the various leases involved in the case.

25 Whereupon the petitioner, to maintain the issues in his behalf, introduced the following testimony:

LAWRENCE R. HAGY, being first duly sworn, testified that he was a geologist and oil and gas operator. He was educated in geology at the University of Oklahoma and since his graduation, has been continuously employed in the oil business. His first activity in the oil business was in southern Oklahoma and Texas. He is familiar with the oil situation in the Panhandle (R. 6), and has had knowledge of it for ten years. He knows property in the Panhandle and has made geological studies of the strata there. He has been familiar with it practically since the inception of the field.

In determining whether or not there is an oil field a geololist would consider three factors that are fundamental in the discovery of an oil pool. It is necessary to have favorable structural condition which would cause accumulation; there must be oil in the vicinity and there must be a forced bed to act as a reservoir to hold the oil. In the Panhandle these conditions exist. This is proved by the fact that they have production throughout a territory of about 120 miles running in a northwesterly direction, starting at Wheeler County and continuing through Moore County. Over this space of approximately 120 miles conditions are generally the same. There is a very enormous structural condition underlaid with granite; it starts in Wheeler County and extends in a northwesterly direction of 120

26 miles. The area is flat along the north side; in other words, the oil accumulates in the base to the north and east of this ridge and has migrated on up the structure until it comes against this granite. There is practically continuous production for forty or fifty miles through this area. (R. 7, 8). Referring to a map (Petitioner's Exhibit No. 3), the witness stated that production starts in Wheeler County and comes

through Wheeler, Gray and Carson Counties and Hutchinson County, where the Herring land is located. It continues in a northwesterly direction. Four wells were drilled on the Herring land, one in the northern part, one in the southern part and two in the east central part. As we go past the Herring land, there is production on the east side where there is a well that made 20,000,000 feet of gas and about twenty barrels of oil. On the Thomas Ross there is a well that made forty-three barrels of oil. There is considerable production in Moore County following the same trend of production. The Herring land lies very favorably to this enormous granite ridge the witness spoke of and the production is flanked up on the side of that. The land lies in a very favorable geological position (R. 8).

The witness is familiar with the four wells drilled on the Herring land. The Gulf well drilled on the Bason Survey, in the northern part of the ranch, made from two to three milion feet of gas with a favorable showing of oil; the well drilled in Section 5 H. and G. N. survey, by the Gulf Petroleum Company, made eleven million four hundred thousand feet of gas and about eight to ten barrels of oil. The well drilled by the Phillips Petroleum Company in Section 7 made four and a half million feet of gas, with a favorable showing of oil. The Magnolia drilled a well opposite that at a short distance, expecting it would have more favorable production conditions, and that well was completed as a five million foot gas well, with a small showing of oil. These wells have been drilled and give proof that the land is more favorably located than it was in the earlier days, because they have later information to go by and in the future wells will be drilled there due to those conditions. The four wells were drilled about 1930 (R. 9). One reason there has not been more drilling, is because of the economic conditions there. They are so far from the Gulf that the Panhandle oil is not worth as much as oil on the Gulf and

27

so they have practically stopped drilling in the Panhandle. They have only fourteen of fifteen wells drilling now while in 1929 they had sixty to one hundred.

The gas business in the Panhandle is just coming into its own. The big line to Chicago was completed last year; the line to Indianapolis was completed last year; they have an outlet for half a billion cubic feet of gas a day. Those lines have been completed and the gas is becoming more valuable all the time, and these gas wells would bring in a very nice return now, where they wouldn't have made a return in 1930. The average price of gas for this area is about four cents a thousand. The wells on the Herring property can be operated very profitably. Developments since 1926 have not in any way condemned the land for oil production. In fact the developments there now give us more information for drilling wells later on. The witness stated it would be easier to locate production on that land than it would have been without any wells drilled around there. There are wells on practically every side; (R. 10). There is production on the south, production to the east, production to the west and wells of twenty to forty barrels on the north and northwest of the land.

28

The wells drilled on the Herring land show the same structural conditions as are typical in the field. The wells are not what would be called good producers but from them the area can be picked out which will be productive. No doubt a number of wells will be developed.

Referring to a contour map (Pet.'s Ex. No. 4), reference was made to a big line from twenty-five to twenty-six hundred feet; the lines show that at one thousand feet above sea level there are wells. Most of the production in the Panhandle is encountered between the 800 foot and 1000 foot contours. The heavy line is the 1000 foot contour. Ninety per cent of the production lies between the 800 and 1000 foot contour. The map shows the production coming through Carson, Gray and

Hutchinson Counties right up to the ridge and
29 if they have the same conditions which exist on the ranch there is no doubt that production will be developed on the ranch. (R. 11, 12.)

It is probable that there may be production under the 800 foot and higher than the 1000 foot line but most of it is between those two. A re-entrant is the thing that caused the concentration of oil in the border pool. The contour map shows that the same condition exists on the Herring land and it is considered that it will tend to make that land more productive, more concentration of oil; it is very favorably situated geologically, from what is known of the Panhandle structural conditions.

From the witness' knowledge of the Herring land, it is very probable they will get oil on it. (R. 12.)

The Herring land was taken on long term leases and there was other oil in the Panhandle that was being developed; the Herring land was owned in large tracts and was not developed. Along in 1929 there was more or less of a depression in the Panhandle in the oil business and there has been very little development since. It is the area that will be prospected in the future as soon as economic conditions improve. The Panhandle oil can not compete with East Texas production because it has a sulphur content which is objectionable and it is very hard to handle particularly in winter because it has so much paraffin in it that it congeals. The production in East Texas, or close to Tidewater,
30 will be used before they go back to the Panhandle to drill more wells.

Without objection, there was introduced in evidence, as Petitioner's Exhibit No. 3, the map showing the oil production in the Panhandle (R. 13).

Without objection, there was introduced, as Petitioner's Exhibit No. 4, a contour map of the Panhandle.

The Panhandle facilities for disposing of gas consists of five completed major traffic lines, one to Denver, one to Chicago, one to Omaha, one to Indianapolis and one to Fort Worth that handle a tremendous amount of gas. The project has all been developed within the last two years, with the exception of the Denver line and the Wichita Falls line. The pipe lines are not considered common carriers and at the present time there is no way that the owner of a gas well can dispose of his gas. The last Legislature wrote an oil and gas law that will make it possible for pipe line companies to transport gas. At the present, pipe line companies own their own gas wells. (R. 14, 15.)

Plans are in existence for constructing other gas lines. River crossings, booster stations, the bases for pumps are so constructed that parallel lines can be laid. Due to financial conditions these lines have been
31 postponed. The Texhoma twenty-four inch line crosses the Herring land. R. 16.)

Upon cross examination the witness testified: He had kept up with practically all the developments in the territory and had examined the geological structure of the Herring property. He had been on the property numerous times but not for the last six months. He started a well immediately south of there in 1926. The well was not on the Herring property but immediately south of it. (R. 16.)

The first gas production in the Panhandle was brought in in 1918, the first oil well about 1922 or 1923. In 1923 a well was discovered about four and one-half miles south of the Herring land. In the same year a well was discovered three and a half miles east of there.

It is possible, but not probable, that there might never be any wells in the Herring property because they have evidence now that there is gas underneath the whole ranch and from what indication they have, it seems very probable that there will be oil there. The evidence was obtained in 1930 (R. 17.)

When there is more demand for oil, the Panhandle will have more production. The East Texas production might last seven years or it might last fifteen years according to the amount of oil taken out per day. The Panhandle production is a continuation of pools along the granite ridge. These pools are all found on the north side of the ridge. In some places the pools are very close together, within two or three miles
32 and in other places about seven miles.

On re-direct examination the witness stated: The gas is continuous throughout that area. (R. 18.) The Panhandle gas, which is of light specific gravity, is on top of the oil and the water is below that. Gas is on top of the Panhandle structure and the oil on the north flank of this structure. The location of gas indicates to a geologist the probability of oil as the two are closely related.

In the Panhandle area production is of a uniform depth, about 100 feet above sea level. The oil is floating on the water which is about at sea level. This is true of the entire Panhandle area, but is not common in other oil pools. The Herring land is north of the granite ridge referred to and is very favorably located. (R. 19.)

In 1926 they had an idea that this general structural condition is like it is today but they did not have the complete information that they have today. The nearest oil production to the Herring land is about a mile and a half due east. In 1926 the nearest production was about three and a half miles.

Upon re-cross examination the witness stated that the discovery of gas is not always followed by the discovery of oil. In the Panhandle oil and gas deposits are found in the lower permean formation (R. 20).

R. S. POWELL, being duly sworn, stated that he resided in Wichita Falls, Texas and was Division Geologist for the Texas Company. He was educated
33 in geology in the Colorado School of Mines and was familiar with the Herring land in the Panhandle. His company had leases there. It has not drilled on the leases yet, but is paying rentals. In 1926, when the company got the lease, they paid a bonus (R. 21).

There were geological indications that oil might be discovered on the land which was the reason that the Texas Company bought the lease. They haven't drilled the land because it is their practice in the Panhandle, due to the large amount of acreage they own in the area, to drill only the acreage which they have to drill. In fact, to keep in line with their economic program, all they drill is offsets; offsets created by the drilling of others keep them busy, and they have not had time and have not had to drill the other.

Upon cross examination Mr. Powell stated that he went with the Texas Company on January 15, 1926 as a geologist. He had never been on the Herring land. He knew about the geology of the Herring land because he figured it out himself from well logs made by drillers. He was never on the property in 1926 (R. 22).

Upon re-direct examination the witness stated that it was not necessary to go on a particular piece of property to know the geology of it. The Texas Company's field men can supply a geologist with sufficient information. Geology today is usually worked by sub-sur-
34 face, in which no surface indications have any relation and that is especially true in the Panhandle. (R. 23.)

The parties certify that the foregoing contains the substance of all the evidence given on the hearing of this proceeding.

ROBERT ASH,
Attorney for Petitioner,
Munsey Building,
Washington, D. C.
E. BARRETT PRETTYMAN,
General Counsel, Bureau of Internal Revenue, Attorney for Respondent.

The statement of the evidence is approved and ordered to be made of record in the above entitled cause this 11th day of Oct., 1933.

(s) EDGAR J. GOODRICH,
Member.

35 EXHIBIT #1.

Form 88—(Prod ers)—Texas.

Oil and Gas Lease.

Agreement, made and entered into 8th day of May, 1926, by and between W. E. Herring, party of the first part, hereinafter called lessor (whether one or more) and Roxana Petroleum Corporation, party of the second part, hereinafter called lessee.

Witnesseth, that the said lessor, for and in consideration of Twenty Dollars and other cash, Dollars cash in hand paid, receipt of which is hereby acknowledged and of the covenants and agreements hereinafter contained on the part of lessee to be paid, kept and performed, has granted, demised, leased and let and by these presents does grant, demise, lease and let unto the said lessee,

for the sole and only purpose of mining and operating for oil and gas, and laying pipe lines, and building tanks, powers, stations and structures thereon to produce, save and take care of said products, all that certain tract of land situate in the County of Hutchinson, State of Texas, described as follows, to-wit: The East one-half of the Southeast Quarter (E½ SE¼), of Section 5, Block "J" H&GN R. R. Co. Survey, and containing eighty (80) acres, more or less.

It is agreed that this lease shall remain in force for a term of five years from date, and as long thereafter as oil or gas, or either of them, is produced from said land by the lessee, and or if lessee shall commence drilling operations at any time while this lease is in force this lease shall remain in force and its terms shall continue so long as such operations continue with due diligence and if production results therefrom then as long as production continues.

In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of lessor, free of cost, in the pipe line to which lessee may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises.

2nd. To pay the lessor one-eighth, at the market price for the gas so used, for the gas from each well where gas only is found, while the same is being used off the premises, and lessor to have gas free of cost from any such well for all stoves and all inside lights in the principal dwelling house on said land during the same time by making his own connections with the wells at his own risk and expense.

3rd. To pay lessor for gas produced from any oil well and used off the premises or for the manufacture of casing head gas, one-eighth, at the market price for

the gas so used, for the time during which such gas shall be used, said payments to be made quarterly.

If no well be commenced on said land on or before the 8th day of May, 1927, this lease shall terminate as to both parties, unless the lessee on or before that date shall pay or tender to the lessor or to the lessor's credit in the Herring National Bank at Vernon, Texas, or its successors, which shall continue as the depository regardless of changes in the ownership of said land, the sum of Eighty & 00/100 Dollars, which shall operate as a rental and cover the privilege of deferring the commencement of a well for 12 months from said date. In like manner and upon like payments or tenders the commencement of a well may be further deferred for like periods of the same number of months successively. And it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privileges granted to the date when said first rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid and any and all other rights conferred.

Should the first well drilled on the above described land be a dry hole, then, and in that event, if a second well is not commenced on said land within twelve months from the expiration of the last rental period which rental has been paid, this lease shall terminate as to both parties, unless the lessee on or before the expiration of said twelve months shall resume the payment of rentals in the same amount and in the same manner as hereinbefore provided. And it is agreed that upon the resumption of the payment of rentals, as above provided, that the last preceding paragraph hereof, governing the payment of rentals and the effect thereof, shall continue in force just as though there had been no interruption in the rental payments.

If said lessor owns a less interest in the above described land than the entire and undivided fee simple

estate therein, then the royalties and rentals herein provided shall be paid the lessor only in proportion which his interest bears to the whole and undivided fee.

Lessee shall have the right to use, free of cost, gas, oil and water produced on said land for its operation thereon, except water from wells of lessor.

When requested by the lessor, lessee shall bury its pipe lines below plow depth.

No well shall be drilled nearer than 200 feet to the house or barn now on said premises, without the written consent of the lessor.

Lessee shall pay for damages caused by its operations to growing crops on said land.

Lessee shall have the right at any time to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing.

If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to their heirs, executors, administrators, successors or assigns, but no change in the ownership of the land or assignment of rentals or royalties shall be binding on the lessee until after the lessee has been furnished with a written transfer or assignment or a true copy thereof; and it is hereby agreed in the event this lease shall be assigned as to a part or parts of the above described lands and the assignee or assignees of such part or parts shall fail or make default in the payment of the proportionate part of the rents due from him or them, such default shall not operate to defeat or affect this lease in so far as it covers a part or parts of said lands which the said lessee or any assignee thereof shall make due payment of said rental.

Lessor hereby warrants and agrees to defend the title to the lands herein described, and agrees that the lessee shall have the right at any time to redeem for lessor, by payment, any mortgage, tax or other liens on the

above described lands, in the event of default of payment by lessor, and be subrogated to the rights of the holder thereof, and lessor hereby agrees that any such payment made by the lessee for the lessor shall be deducted from any amounts of money which may become due the lessor under the terms of this lease.

Lessor hereby waives all statutory claims to the above described lands as his homestead, his homestead being in Amarillo, Potter County, Texas.

In testimony whereof, we sign, this the 8th day of May, 1926.

W. E. HERRING. (Seal)
..... (Seal)
..... (Seal)

Witness:

.....
.....

(Copy.)

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36 DESIGNATION OF RECORD.

Filed Sep. 28, 1933.

William E. Herring, Petitioner,

vs. Docket No. 47041

Commissioner of Internal Revenue, Respondent.

United States Board of Tax Appeals.

To the Clerk of the United States Board of Tax Appeals:

Will you please prepare and transmit to the Clerk of the United States Circuit Court of Appeals for the Fifth Circuit certified copies of the following documents in the above entitled case:

1. Docket entries of proceedings before the United States Board of Tax Appeals.

2. Petition.

3. Answer.

4. Memorandum Opinion of the Board.

5. Decision (Order of redetermination) of Board.

6. Petitioner's Exhibit No. 1 (Specimen lease).

7. Petitioner's Exhibit No. 2 (Map showing leases).

8. Petitioner's Exhibit No. 3 (Map showing production in Panhandle field).

9. Petitioner's Exhibit No. 4 (Contour map showing geological structure.)

10. Statement of the evidence as settled or agreed upon.

37 11. Petition for review.

12. This designation of record.

The foregoing to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Apeals for the Fifth Circuit.

ROBERT ASH,
Attorney for Petitioner,
Munsey Building,
Washington, D. C.

38 CERTIFICATE.

(Title Omitted.)

I, B. D. GAMBLE, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 37, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 19th day of Oct., 1933.

B. D. GAMBLE,
Clerk, United States Board of
(Seal) Tax Appeals.

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39 ORDER.

(Title Omitted.)

It appearing that it is proper and necessary that certain exhibits be transmitted to the United States Circuit Court of Appeals, Fifth Circuit, as physical exhibits for inspection by the said Court, and in accordance with stipulation of the parties pursuant to Rule 34 of the Court, it is

Ordered that Petitioner's Exhibits 2, 3 and 4 be transmitted to the United States Circuit Court of Appeals, Fifth Circuit, in connection with petition for review of the above proceeding, said Exhibits to be returned to the Board after they have served their purpose in the Court.

(Signed) EDGAR J. GOODRICH,
(Seal) Member.

Dated Washington, D. C.,
Oct. 11, 1933.

[fol. 37] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:

No. 7214

WILLIAM E. HERRING

versus

COMMISSIONER OF INTERNAL REVENUE

ARGUMENT AND SUBMISSION

Extract from the Minutes of March 7th, 1934

On this day this cause was called, and after argument by Robert Ash, Esq., for petitioner, and Milford S. Zimmerman, Esq., Special Assistant to the Attorney General, for respondent, was submitted to the Court.

[fol. 38] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 7214

WILLIAM E. HERRING, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of Decision of U. S. Board of Tax Appeals (District of Texas)

Before Bryan, Sibley and Walker, Circuit Judges

OPINION OF THE COURT AND DISSENTING OPINION OF SIBLEY, CIRCUIT JUDGE—Filed April 24, 1934

WALKER, Circuit Judge:

During the year 1926 the Petitioner and his wife each owned a 50% interest in the partnership of C. T. Herring & Son, and they filed separate income tax returns for that

year under the community property laws of the State of Texas. In 1926 the partnership owned several ranches in the vicinity of Amarillo, Texas, and its principal business was cattle raising. During that year it leased, for a period of five years, portions of its ranches to sundry individuals and corporations "for the sole and only purpose [fol. 39] of mining and operating for oil and gas, and laying pipe lines, and building tanks, power stations and structures thereon to produce, save and take care of said products." Under those leases the partnership received as cash bonuses therefor a total of $683,793.75. No oil development had been begun on any of the leased land at the dates of the leases, and at those dates there was no oil well within 3½ miles of the leased land. During the year1926 there was no oil production on the leased land. No wells were sunk on the leased land until the year 1930, during which four wells were sunk, with the result that gas and oil were produced. In the partnership return for the year 1926 a depletion deduction was taken in the amount of $18,043.28, being 27½ per cent of the total amount of bonus receipts. In his income tax return for that year the Petitioner deducted from the amount of his gross income one-half of the amount of the above mentioned deduction taken in the partnership return. This deduction was disallowed by the Respondent, with the result that Petitioner's distributive share of the partnership net income was increased, and a deficiency of $11,337.29 was determined. The Board of Tax Appeals sustained that action of the Respondent. The action of that tribunal is complained of by petition for review.

The question presented is whether the Petitioner was entitled to deduct from his 1926 gross income the whole or a part of the amount of the deduction claimed by him on account of depletion. The following are the governing statutory provisions: "In computing net income there shall be allowed as deductions: * * * A reasonable allowance for the exhaustion * * * of property used in the trade or business. * * * In the case of mines, oil and gas wells, and other mineral deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in [fol. 40] each case," etc. § 214 (a) (9) Revenue Act of 1926, 44 Stat. 26, 26 U. S. C. A. § 955 (a) (9): "Sec. 204.

(c). The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that— * * *

(2) In the case of oil and gas wells the allowance for depreciation shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." Revenue Act of 1926, 44 Stat. 9, 26 U. S. C. A. § 935.

For support of the contention of the Petitioner much reliance is placed on the decision in the case of Murphy Oil Co. v. Burnet, 287 U. S. 299, to the effect that where the execution of an oil and gas lease is followed by the production of oil a depletion allowance must be made in respect to a bonus paid to the lessor. The report of that decision contains no statement as to whether oil was or was not extracted from the leased land during the taxable years in question, 1919 and 1920. But from the report of the decision which was affirmed in that case it appears that the leased land produced oil in each of those years. Murphy Oil Co. v. Burnet, 55 Fed. (2), 17. The court which rendered the decision which was affirmed by the Supreme Court expressly ruled that the depletion allowable to the lessor in an oil lease was limited to actual depletion during the taxable years in question. The decision of the Supreme Court in that case does not support a contention that a deduction for depletion with respect to a bonus payment is allowable to a taxpayer who, during the taxable year in question, received that bonus upon his executing an oil and gas lease covering land [fol. 41] which during that year contained no oil or gas well, but in which several years later were sunk wells which produced oil and gas. We think it cannot reasonably be said that the provision allowing, "in the case of * * * oil and gas wells", a deduction from gross income for depletion discloses an intention to authorize the allowance of such a deduction from a taxpayer's gross

income in a year in which he had no interest in any then existing oil or gas well, but during which he received a bonus upon his execution of an oil and gas lease covering land which had never been explored for oil or gas by sinking a well or starting to sink one, but in which several years later were sunk wells which produced oil or gas. The deductions from gross income authorized by an above cited statute are based upon happenings or facts existing during the taxable year in question which are regarded as having the effect of offsetting to some extent the taxpayer's gains or profits realized or accrued during that year, and may involve some return of the taxpayer's capital investment. In the case of Lynch v. Alworth-Stephens Co., 267 U. S. 364, the court construed and applied the provisions of the Income Tax Law of September 6, 1916, as to deductions based on exhaustion or depletion of mines. The following are extracts from the opinion in that case: "In the case of mines, a specific kind of property, the exhaustion is described as depletion, and is limited to an amount not exceeding the market value in the mine of the product mined and sold during the year. The interest of respondent in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year results from the plain terms of the statute, such deduction, since the property is an interest in mines, to be limited to the amount of the exhaustion of respondent's interest caused by the depletion of the mines during the taxable year. We agree with the Circuit Court of Appeals, 294 Fed. 194, that, [fol. 42] 'The plain, clear and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to every one whose property right and interest therein has been depleted by the extraction and disposition of the product thereof which has been mined and sold during the year for which the return and computation are made.' * * * The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property." As to the measurement or determination of the amount of allowable depletion deduction the statute applicable in the instant case is different from the one which was construed and applied in the cited case. But the statute applicable in thei instant

case, we think not less clearly than the one which was construed and applied in the cited case, discloses a legislative intention to allow a deduction for depletion only when depletion occurs during the taxable year in question. In the case of Burnet v. Thompson Oil & G. Co., 283 U. S. 301, a taxpayer claimed that it was entitled to a deduction from gross-income for depletion which would represent not only that year's sustained depletion, but make up for sustained but disallowed depletion in earlier years. In rejecting that claim the court said: "The tax is an income tax for 1918, and in the absence of express provision to the contrary, it is not to be supposed that the taxpayer is authorized to deduct from that year's income, depreciation, depletion, business losses or other similar items attributable to other years. The very fact that Congress denied deductions equal to the sustained depletion in the earlier years negatives an intent that they should be allowed in later years, as if for depletion then sustained. The construction adopted by the court below in effect results in including in the taxable year items referable to other years, and is contrary to the theory of a tax for specific years.

The nature of the tax as one for annual periods has been [fol. 43] repeatedly mentioned in dealing with its application in various situations. The taxable year 1918, and that only, is involved, and deductions applicable to that year only should be allowed."

Petitioner claimed that in the computation of his income tax liability for the year 1926 he was entitled to a depletion deduction from his gross income with respect to the amount of bonuses he received in that year, though in that year there was no depletion or reduction of the oil or gas in place in the land covered by the leases on which the bonus payments were made. It was suggested in argument that, by reason of Petitioner's receipt in that year of the large sum in bonuses, depletion allowances made in that year probably would be more beneficial to Petitioner than such allowances made in later years were likely to be. It was not claimed that the applicable statute providing for depletion allowances "in the case of oil and gas wells", or any Regulation under that statute, contains anything indicating an intention to change the rule that a depletion reduction from gross income in a taxable year in question must be based on depletion which occurred in that year.

We summarize: Petitioner claimed in effect that, without showing that any depletion occurred in the year 1926, he was entitled to a depletion deduction from his gross income for that year. The bonuses he received in 1926 constituted income of Petitioner in that year. Burnet v. Harmel, 287 U. S. 103. The burden was on him to show that he was entitled to the deduction claimed. Brown v. Helvering, U. S. Sup. Ct. Jan. 15, 1934. The depletion charge permitted as a deduction from gross income in determining taxable income "in the case of oil and gas wells" represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest. Helvering v. Falk, U. S. Sup. Ct. Jan. [fol. 44] 15, 1934; United States v. Luden, 274 U. S. 295, 302. No statutory provision which has come to our notice authorizes such a deduction to be based on an expectation, however well founded, that oil or gas remaining in place in land during the taxable year in question will be extracted in subsequent years. Depletion of oil or gas is a result of the production and sale thereof. Palmer v. Bender, 287 U. S. 551, 558. Instead of the applicable statute specifically allowing, "in the case of oil and gas wells", a depletion deduction from gross income in a taxable year in which no depletion of oil or gas is shown to have occurred, the language of that statute indicates the absence of any intention of the lawmakers to depart from the established rule that a depletion deduction from gross income for a taxable year is allowable only when depletion occurred in that year.

The deduction claimed by Petitioner, not being authorized specifically by the applicable statute or any Regulation thereunder, was properly disallowed. Burnet v. Thompson Oil & G. Co., supra; Brown v. Helvering, supra.

The petition for review is Denied.

Sibley, Circuit Judge, Dissenting:

The question is whether a percentage depletion is allowable on bonuses received in 1926 for oil and gas leases which [fol. 45] are to endure so long as oil or gas is produced when no well was drilled and no oil produced under them during that year, although the oil and gas were present and were produced later. The Board of Tax Appeals denied the allowance because there was no well, and this court denies it

because no oil was taken out. One of the pertinent provisions of the Revenue Act of 1926, "In computing net income there shall be allowed a deduction * * * in the case of mines, oil and gas wells, and other mineral deposits and timber, a reasonable allowance for depletion and for depreciation of improvements according to the peculiar conditions in each case", occurred in previous Acts. The other provision: "In case of oil and gas wells the allowance for depletion shall be 27½ percentum of the gross income from the property during the taxable year", is new. Great difficulty was found under the former provision in estimating the content of an oil and gas reserve under the ground and in arriving at what proportion of it was represented by the operations of a particular taxable year, and also in fixing the value of the reserve under the rules relating to discovery value. To avoid these difficulties Congress in the new provision ignored both the size and the value of the reserve, assumed that the value of any production of oil or gas would on the average be 27½ percent original capital investment not to be taxed, and the remaining 62½ per cent would be taxable income, and provided for its taxation in the year it was received. It is evident that the 27½ percent deduction which the statute not only permits but commands must be made in the year that the income which measures it is received and taxed, that it cannot be taken any subsequent year, and that it is entirely independent of actual depletion, being so named because it looks forward or backward to the exhaustion represented by the income received. The purpose and command of the provision is de-[fol. 46] feated by the decision in this case. The oil and gas were present to be produced, as was of course supposed when nearly a half-million dollars were paid in advance for them as bonuses, and as was proven when the wells were drilled. That the lessees by their own choice not to drill the first year should control the taxability of the lessor's bonuses, or that the depletion allowance on the entire bonuses should depend on the production in the taxable year of a few gallons of oil or a few feet of gas seems to me both unreasonable under the general provision for depletion and in contradiction of the special provision for the percentage deduction.

It is true that depletion, like depreciation because of wear and tear and obsolescence, is based on the actual gradual loss of capital. The allowance for wear and tear

and obsolescence is, however, always estimated and distributed over the useful life of the property considered, and does not depend on a demonstration of what actually happened to it in the particular taxable year. The allowance for them is a general offset against all income for the taxable year rather than a deduction from some particular item of income, because wear and tear and obsolescence, although a loss of capital, do not directly produce any particular income. Depletion also may sometimes be a mere loss, as when oil or gas runs to waste or standing timber dies and rots. But ordinarily depletion refers to a commercial use of part of a reserved store, as where ore or gas or oil is extracted for sale, or timber or ore or oil is manufactured into lumber or metal or gasoline and sold. In such cases the capital represented by the depletion is used directly to produce income and is converted into it. According to Eisner vs. McComber, 252 U. S. 189, only gain is taxable income under the Sixteenth Amendment where a conversion of property is involved. Congress is therefore merely staying on safe constitutional ground in providing for this percentage depletion against income received from [fol. 47] oil and gas. If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his reciept of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timber, he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil

expected to be recovered by the lessee. Both are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. Burnet v. Harmel, 287 U. S. 103; Murphy Oil Co. vs. Burnet, 287 U. S. 299; Bankers Coal Co. vs. Burnet, 287 U. S. 309; Palmer vs. Bender, 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has [fol. 48] always been that a reasonable allowance shall be made according to the peculiar conditions of each case. Construing it as to a bonus, it is said in Murphy Oil Co. vs. Burnet, supra, at page 307: "Here an anticipated depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such anticipated depletion to a payment made in advance of its occurrence. The alloaction is permitted by statute." This language is quite at variance with that of the court below quoted in the majority opinion. When this provision was first enacted in 1918, Regulation 45, Art. 215 (d), provided that on the expiration or abandonment of a lease without the removal of any or all of the mineral contemplated by the lease, there must be a return to capital account of so much of the bonus deducted from the recoverable capital as exceeds actual depletion, and that amount must be treated as income the year the lease was ended. This shows that it was understood that the bonus payment was considered depletable in advance of actual depletion, and that if the contemplated depletion does not occur the correction is to be made at the end of the lease. The same Regulation has been continued ever since, as Congress has reenacted the same depletion provision, and it is referred to and its operation approved in Murphy Oil Co. vs. Burnet, supra, at page 304, and again at page 306. The statutory words: "In case of oil and gas wells" are directly connected with "or other mineral deposits." Wells as such were not in the mind of Congress as subjects of depletion, but the deposits of oil and gas and other minerals were in mind, and as shown above, depletion of bonuses on leases was regularly allowed although in most cases, no doubt, actual production is not accomplished in the year the lease is made. When in the Act of 1926 Con-

gress again used the expression, "In cas eof oil and gas wells" in connection with the percentage depletion, no nar-
[fol. 49] rower meaning is to be attributed to it. United States vs. Dakota-Montana Oil Co., 288 U. S. 459. On the contrary, even more plainly the receipt of income and not the existence of a well or of production from it is made the generating cause of the depletion allowance. If the tax officer treats a bonus payment as income, he must deplete it 27½ percent under the command of the statute.

In Helvering vs. Falk, — U. S. —, depletion under all the Acts through that of 1926 was under consideration and the cases were reviewed with this conclusion: "Whatever may be said concerning the power of Congress to treat the entire proceeds of a mine as income, obviously the statute has not undertaken to do so. The plain purpose we think was to tax only that portion of the proceeds remaining after proper allowance for depletion. This allowance represents property consumed, is treated as if capital assets, and no tax is laid upon it. The statute must be so applied in practice as to carry out this purpose." The judgment in the case at bar defeats the statutory purpose and by denying the allowance which the statute commands taxes that part of the money received which ought to be treated as if capital assets.

A true copy. Teste:

—— ——, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit.

[fol. 50] No. 7214

WILLIAM E. HERRING

versus

COMMISSIONER OF INTERNAL REVENUE

JUDGMENT

Extract from the Minutes of April 24th, 1934

This cause came on to be heard on the petition of William E. Herring for a review of a decision of the United States Board of Tax Appeals, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that said petition be, and the same is hereby, denied.

"Sibley, Circuit Judge, dissenting."

[fol. 57] No. 7214

WILLIAM E. HERRING

versus

COMMISSIONER OF INTERNAL REVENUE

ORDER DENYING REHEARING

Extract from the Minutes of June 8th, 1934

As neither of the judges who concurred in the decision of the court in the above numbered and entitled cause is of opinion that the petition for rehearing should be granted, it is ordered that the said petition be and the same hereby is denied.

[fol. 58] UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 7214

WILLIAM E. HERRING, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Motion to Stay Mandate

MOTION AND ORDER STAYING MANDATE—Filed June 14th, 1934

Comes now the above named petitioner and moves that the mandate be stayed pending application for writ of certiorari.

(Signed) Robert Ash, Munsey Bldg., Washington, D. C., Attorney for Petitioner.

[fol. 59] UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH DISTRICT

No. 7214

WILLIAM E. HERRING, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

On consideration of the application of the Petitioner in the above numbered and entitled cause for a stay of the mandate of this court therein, to enable Petitioner to apply for and to obtain a writ of certiorari from the Supreme Court of the United States, it is ordered that the issue of the mandate of this court in said cause be and the same is stayed for a period of thirty days; the stay to continue in force until the final disposition of the case by the Supreme Court, provided that within thirty days from the date of this order there shall be filed with the clerk of this court the certificate of the clerk of the Supreme Court that the certiorari petition and record have been filed, and that due proof of service of notice thereof under Paragraph 3 of Rule 38 of the Supreme Court has been given. It is further ordered that the clerk shall issue the mandate upon the filing of a copy of an order of the Supreme Court denying the writ, or upon the expiration of thirty days from the date of this order, unless the above-mentioned certificate shall be filed with the clerk of this court within that time.

Done at New Orleans, La., this 14th day of June, 1934.

(Signed) Rufus E. Foster, United States Circuit Judge.

[fol. 60] CLERK'S CERTIFICATE

UNITED STATES OF AMERICA:

UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

I, Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, do hereby certify that the pages numbered from 37 to 59 next preceding this certificate contain full, true and complete copies of all the

pleadings, record entries and proceedings, including the opinion of the United States Circuit Court of Appeals for the Fifth Circuit, in a certain cause in said Court, numbered 7214, wherein William E. Herring is petitioner, and the Commissioner of Internal Revenue is respondent, as full, true and complete as the originals of the same now remain in my office.

I further certify that the pages of the printed record numbered from 1 to 36 are identical with the printed record upon which said cause was heard and decided in the said Circuit Court of Appeals.

In testimony whereof, I hereunto subscribe my name and affix the seal of the said Circuit Court of Appeals, at my office in the City of New Orleans, Louisiana, in the Fifth Circuit, this 15th day of June, A. D. 1934.

Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals, Fifth Circuit. (Seal United States Circuit Court of Appeals, Fifth Circuit.)

[fols. a-1] UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

Docket No. 7215

EULA DAY HERRING, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Stipulation

JOINT STIPULATION AND ORDER TO PRINT THE RECORD IN THE CASE NO. 7214, AND TO OMIT THE PRINTING OF THE RECORD IN CASE NO. 7215, ETC.—Filed November 8, 1933

Whereas the issues in the above entitled cause are precisely the same as the issues in the action entitled William E. Herring v. Commissioner of Internal Revenue, and as the proceedings were consolidated, heard, and disposed of before the United States Board of Tax Appeals on one record, and as the transcript of record on the petitions for review are the same, except as to names, no useful purpose

could be served by hearing the cases separately before this honorable court.

It is therefore stipulated and agreed by and between the parties in the above entitled cause, through their respec-
[fol. 2] tive attorneys, that the printing of the transcript record in this cause may be dispensed with and that the decision of the court in the case of William E. Herring v. Commissioner of Internal Revenue will control and will be accepted by the parties as the decision in the above entitled case.

(Signed) Robert Ash, Attorney for Petitioner.
(Signed) E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue.

[fol. 3] UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

No. 7214

WILLIAM E. HERRING, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

No. 7215

EULA DAY HERRING, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

It is ordered that the record in case No. 7214, William E. Herring, petitioner, vs. Commissioner of Internal Revenue, respondent, be printed, but that the printing of the record in case No. 7215, Eulay Day Herring, petitioner, vs. Commissioner of Internal Revenue, respondent, be omitted; that a like judgment be entered in case No. 7215, Eula Day Herring, petitioner, vs. Commissioner of Internal Revenue, respondent, as in case No. 7214, William E. Herring, petitioner, vs. Commissioner of Internal Revenue, respondent.

(Signed) N. P. Bryan, U. S. Circuit Judge.

November 8, 1933.

[fol. 4] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:

No. 7215

EULA DAY HERRING

versus

COMMISSIONER OF INTERNAL REVENUE

ARGUMENT AND SUBMISSION

Extract from the Minutes of March 7th, 1934

On this day this cause was called, and, after argument by Robert Ash, Esq., for petitioner, and Milford S. Zimmerman, Esq., Special Assistant to the Attorney General, for respondent, was submitted to the Court.

[fol. 5] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 7215

EULA DAY HERRING, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of Decision of U. S. Board of Tax Appeals (District of Texas)

Before Bryan, Sibley, and Walker, Circuit Judges

OPINION OF THE COURT AND DISSENTING SIBLEY, CIRCUIT JUDGE—Filed April 24, 1934

By the COURT:

The parties to the above numbered and entitled cause by written stipulation filed therein having agreed that the decision of this court in the cause, numbered 7214 on the docket of this court, wherein William E. Herring is Pe-

titioner and the Commissioner of Internal Revenue is Respondent, will control and be accepted by the parties to the first above numbered and entitled cause as the decision of this court; and this court having rendered its decision in said cause numbered 7214, wherein William E. Herring [fol. 6] is Petitioner and the Commissioner of Internal Revenue is Respondent, whereby the petition for review therein was denied; it is ordered that the petition for review in the first above mentioned and entitled cause be, and the same is, denied.

Sibley, Circuit Judge, dissenting.

A true copy. Teste.

—— ——, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit.

[fols. 7-10] No. 7215

EULA DAY HERRING

versus

COMMISSIONER OF INTERNAL REVENUE

JUDGMENT

Extract from the Minutes of April 24th, 1934

This cause came on to be heard on the petition of Eula Day Herring for a review of a decision of the United States Board of Tax Appeals, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that said petition be, and the same is hereby, denied.

"Sibley, Circuit Judge, dissenting."

[fol. 59] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1934

No. 176

WILLIAM E. HERRING, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

ORDER ALLOWING CERTIORARI—Filed October 8, 1934

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[fol. 60] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1934

No. 177

EULA DAY HERRING, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

ORDER ALLOWING CERTIORARI—Filed October 8, 1934

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

FILED
JUL 14 1934
CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

October Term 1934

Nos. 176 and 177

WILLIAM E. HERRING and EULA DAY HERRING, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE

Supreme Court of the United States

October Term 1934

Nos. ——— and ———

WILLIAM E. HERRING and EULA DAY HERRING, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

Your petitioners, William E. Herring and Eula Day Herring pray that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Fifth Circuit in the above entitled cases (which were numbered 7214 and 7215 in the Circuit Court of Appeals) entered April 24, 1934 (R. 46), petition for rehearing denied June 8, 1934 (R. 53). The said judgments (Judge Sibley dissenting and delivering a dissenting opinion) denied petitions for review, and affirmed decisions of the United States Board of Tax Appeals. The opinions of the court below (R. 37) are reported in 70 Fed. (2d) 785. The opinion of the Board of Tax Appeals (R. 13) was a memorandum opinion which is not officially reported. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented

In computing net taxable income for 1926 under the Revenue Act of 1926, are the petitioners entitled to deduct the statutory allowance for depletion from the advance royalties or "bonuses" received by them in 1926 from various lessees to whom ordinary oil and gas leases were granted in that year? Or must they lose that allowance because the lands leased were not producing oil or gas when the respective leases were made and because the lessees did not develop and produce oil or gas under the leases until after 1926?

Statutes and Regulations Involved

Section 214(a) 1926 Act.

> "In computing net income there shall be allowed as deductions:
>
> • • • • • • • •
>
> (9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

Section 204(c) 1926 Act.

> "The basis upon which depletion, exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—
>
> (1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of

a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(2) In the case of oil and gas wells the alolwance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Art. 216, Regulations 69.

"*Depletion—Adjustments of accounts based on bonus or advanced royalty.*

"(a) *Where a lessor receives a bonus in addition

---

*Article 215(a) of Regulations 45 (1918 Act) read as follows:

"Where a lessor received a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Treasury Decision 3938, promulgated November 13, 1926, C.B. Dec. 1926, pg. 117, changed subdivision (a) to read as follows:

"Where a lessor receives a bonus in addition to royalties, there shall

to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * * * *

"(c) §If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

* * * * * * * *

"(e) *In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property."

---

be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

Murphy Oil Co. v. *Burnet*, 287 U. S. 299, dealt with subdivision (a) as originally promulgated and as amended.

§All regulations beginning with those under the 1918 Act have contained a provision identical with subsection (c).

*This subsection was first introduced into the regulations under the 1926 Act, due to the option contained in that Act to compute oil and gas depletion by the "percentage" method.

Statement

During the year 1926 the community estate of William E. Herring and wife owned a 50% interest in the partnership C. T. Herring & Son. For that year petitioner William E. Herring and his wife, petitioner Eula Day Herring, filed separate income tax returns under the community property laws of Texas. In 1926 the partnership owned a large tract of land in the vicinity of Amarillo, Texas, and its principal business was cattle raising. During 1926 the partnership leased portions of its land to sundry individuals and corporations for the "sole and only purpose of mining and operating for oil and gas," etc. These leases were in all respects the customary oil and gas leases (R. 30). The various lessees paid in the aggregate to the partnership lessor, in 1926, $683,793.75 as advance royalties or bonuses and agreed to pay further royalties of 1/8th of the product or its value as oil or gas was actually produced under the leases.

The lessor had no control over the time wells would be drilled by the various lessees. At the time the leases were executed and during the remainder of the year 1926 there was no oil or gas well on the land. However, in 1930 four wells were drilled, all of which were commercial gas wells, all had a showing of oil and one produced from eight to ten barrels of oil a day.

In 1926, when the leases were executed, it was highly probable that the land would, when explored, produce oil or gas or both. This is shown in the record by the fact that wells comparatively close and on all sides of the property were producing; by uncontradicted expert testimony as to geological conditions and, perhaps more convincing to those who cannot qualify as technical oil and gas men, by the fact that numerous persons and corporations engaged in the oil and gas business were willing to pay sums aggregating $683,793.75 for the privilege of exploring the property for oil and gas.

The partnership claimed its members were entitled to a

deduction in 1926 on account of depletion in the aggregate amount of $188,043.28, which represented 27½% of the advance royalties or bonus payments. Each of the present petitioners deducted from income on their income tax returns their proportionate share of the said depletion deduction claimed by the partnership. The Commissioner of Internal Revenue refused to allow the deduction on the ground that "the property on which depletion was claimed was neither proven nor producing during the year in question." The Board of Tax Appeals, in a memorandum opinion, affirmed the Commissioner on the authority of *Lizzie H. Glide,* 27 B.T.A. 1264, which held that there must be a well on the property before the lessor could be allowed the depletion deduction. The Circuit Court of Appeals, Sibley, Circuit Judge, dissenting, affirmed the Board on the ground that there was no production on the property within the taxable year.

Specification of Errors to Be Urged

1. The Court below erred in holding that advance royalties or bonuses are not subject to depletion.

2. The Court below erred in not holding that percentage depletion is based upon income, the allowance of which looks forward or backward to actual production.

3. The Court below erred in denying petitioners the reasonable allowance for depletion which the statute permits.

4. The Court below erred in affirming the Board of Tax Appeals.

Reasons for Granting the Writs

1. The majority decision below is contrary to the decisions of this Court in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Burnet* v. *Harmel,* 287 U. S. 103, and to long established Treasury Regulations.

In dealing with cost depletion the Commissioner of Internal Revenue has, since 1918, held that advance royalties or bonus payments are subject to depletion. See Article 215, Regulations 45 and 62 (1918 and 1921 Acts), Article

216 Regulations 65 and 69 (1924 and 1926 Acts). Article 216(e), Regulations 69, dealing with percentage depletion, which was first introduced into the 1926 Act, continued the established rule and specifically states that the depletion deduction may be taken by the lessor "in respect of any bonus, royalties and other income from the property," etc.*

The Regulations under the 1918 Act were questioned by the Board of Tax Appeals which held, in *Murphy Oil Co.*, 15 B.T.A. 1195, that, as a bonus bore no relationship to production, it could not be subject to a depletion deduction. The Circuit Court of Appeals for the Ninth Circuit reversed the Board in the Murphy case, 55 Fed. (2d) 17, and this Court granted certiorari.

Before this Court passed on the Murphy case it disposed of *Burnet* v. *Harmel,* 287 U. S. 103, in which present counsel contended that a bonus received for executing an oil and gas lease in Texas was taxable as "capital gain" because, under Texas law, the leases conveyed fee title to the minerals in place. In disposing of the case this Court denied the taxpayer's contention largely on the ground that the bonuses involved were advance royalties subject to depletion. There was no showing in the Harmel case that there was oil upon the property when it was leased or that production was obtained thereon in the same year or later.§

The Court in the Harmel case states (P. 111):

> "The Court below thought that the bonus payments, as distinguished from the royalties, should be treated as capital gain, apparently because it assumed that the statute authorizes a depletion allowance upon the royalties alone. See Ferguson v. Commissioner of Internal Revenue (C.C.A. 5th) 45 F. (2) 573, 577. But

*Article 215 of Regulations 45 and Article 216 of various regulations are set forth at page 3 of this petition.

§In its brief filed in the Harmel case in this Court the Government argued, without qualification, that the lessor was entitled to depletion on the advance royalty, and therefore, the advance royalty should not be taxed as capital gain.

> bonus payments to the lessor have been deemed to be subject to depletion allowances under Section 214(a) (9) Revenue Act of 1924, by Art. 216, Treasury Regulations 65, as well as under earlier acts. Section 214(a) (10), Revenue Act of 1921, Art. 215, Treasury Regulations 62. Cf. Murphy Oil Co. v. Burnet (C.C. A. 9th) 55 F. (2d) 17. The distinction, so far as we are advised, has not been taken in any other case * * * We see no basis for it."

The Court's conclusion in the Harmel case was based, to some extent, on the decision in *Work* v. *U. S.* ex rel *Mosier,* 261 U. S. 352, which held that bonuses were advance royalties.

The Harmel decision was followed shortly thereafter by the decision in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, wherein this Court was dealing with the question of whether a substantial bonus or advance royalty paid to a lessor of oil land by his lessee was non-depletable income in its entirety when received, or whether, by an allowance for depletion with respect thereto, the basic depletable value should be reduced, so that, in later years, the allowance for depletion on ordinary royalties, would be based upon such depletable value less the depletion allowable with respect to the advance royalty, instead of upon the full value, as would have been the case if no depletion had been allowable with respect to the advance royalty. This Court said (P. 302) that it was no longer open to doubt that:

> "* * * when the execution of an oil lease is followed by production of oil, the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Section 234. See Burnet v. Harmel, supra. This is obvious where royalties alone are insufficient to return the capital investment. A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, *making no provision for a reasonably anticipated production of oil on the leased premises,* would deny the 'reason-

> able allowance for depletion' which the statute provides. * * * Doubts, if any, whether the statute authorizes depletion of bonus payments have been definitely set at rest by the repeated re-enactment, without substantial changes, of the provisions of Sec. 234(a)(9) since the promulgation of treasury regulations providing for such depletion. * * * In addition, provision is made by subdivisions (c) and (d) of the Regulations, as amended, for such necessary capital readjustments as may be occasioned by the termination, abandonment or expiration of the lease before all the oil is extracted."*

In *Palmer* v. *Bender,* 287 U. S. 551, this Court held that what might be termed a "sub-lessor," who received a cash payment or over-riding royalty, or both, from his sublessee, was entitled to an allowance for "discovery" depletion, saying (P. 557):

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. * * * The benefit of it ('discovery' depletion) accrues to the discover if he operates the well as owner or lessee, or if he leases it to another. It would be an anomoly if that policy were to be defeated and all benefit of the depletion allowance withheld because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another."

In the present case, the allowance for depletion based upon a percentage of income from the property can never be made as to the royalty collected in advance unless made

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*In the *Murphy* case, the fact that oil was produced from the property during the year the bonus was collected and subsequent thereto was fortuitous, and this Court does not appear to have placed any weight on this fact. It seems clear that this Court's decision in the *Murphy* case would have been the same if the bonus or advance royalty had been collected the last moment of the tax year so that there could be no production, and, therefore, no actual depletion of oil reserves in that year.

in the year in which the advance royalty is collected. If the lessor had developed the property himself, or leased without advance royalty, but with a larger ordinary royalty, he would have been allowed depletion on all his royalties when received. The Court below denied the depletion allowance, which the taxpayer must have to place him on equal footing with others similarly situated, from a practical standpoint, solely because of the fortuitous circumstances that the oil was developed by a lessee, who chose to begin operations in a later year, even though had development not been successful, and had no "actual depletion" occurred, the allowance would have been restored to income and taxed in the year this possibility materialized.* For an actual return of his capital, Herring in this case, as was true in the Palmer case, must look alone to the production of oil for the return of his capital, but the allowance looks forward or backward to actual production.§

The controlling statute here expressly required the allowances for depletion to "be equitably apportioned between the lessor and lessee." (Sec. 214 (a) (9) Rev. Act. of 1926.)

The allowance for depletion of the type here involved is predicated primarily upon income. The allowance is 27½% of the gross income, but not more than 50% of the net income, from the property each year. Considered with the Regulations heretofore quoted, it plainly appears that the allowance depends upon receipts more than actual exhaustion of oil or gas reserves, and that, if the allowance

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*Article 216 of Regulations 69 provides: "(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid."

§See Judge Sibley's dissenting opinion in this case, R. 42.

be not made as the receipts come in and are taxed, the Congressional intention of allowing, over the life of the property to every one having an economic interest in the property, 27½% of their respective gross incomes therefrom cannot be carried out. On the other hand, if the allowance is made as royalties are received, any allowance not followed by actual depletion through production can be recovered and taxed by the terms of the Regulation heretofore quoted.

The majority below in the case at bar held that a lessor was not entitled to the statutory allowance for depletion with respect to advance royalties unless oil or gas was actually produced from the property during the tax year in which the advance royalties or bonus was received:

> "The depletion charge permitted as a deduction from gross income in determining taxable income 'in the case of oil and gas wells' represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest. Helvering v. Falk, U. S. Sup. Ct., Jan. 15, 1934; U. S. v. Ludey, 274 U. S. 295, 302. No statutory provision which has come to our notice authorizes such a deduction to be based on an expectation, however well founded, that oil or gas remaining in place in land during the taxable year in question will be extracted in subsequent years. Depletion of oil or gas is a result of the production and sale thereof. Palmer v. Bender, 287 U. S. 551, 558." (R. 42.)

The majority opinion takes no notice of the fact that an allowance for "percentage" depletion can only be taken as to advance royalties in the year the royalties are taxed; and that, in cases where "percentage" depletion is not applied, the allowance with respect to the bonus or advance royalty *will not* be made in any other year; and that, in neither case, can subsequent allowances be increased on account of the fact that no depletion was al-

lowed on the advance royalty.* Nor does it refer to the fact that, if depletion is allowed with respect to an advance royalty, and no oil or other mineral is produced by the lessee during the life of the lease, the lessor is required to restore the allowance to his accounts and to report it as income in the year the lease is terminated.§

Petitioners' view that the majority opinion below is in conflict with the decisions of this Court heretofore mentioned is reinforced by the similar view of the minority below. Judge Sibley, in dissenting said:

> "Both (bonuses and ordinary royalties) are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. Burnet v. Harmel, 287 U. S. 103; Murphy Oil Company v. Burnet, 287 U. S. 299; Bankers Coal Co. v. Burnet, 287 U. S. 309, Palmer v. Bender, 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been that a *reasonable* allowance shall be made *according to the peculiar conditions in each case.* Construing it as to a bonus, it is said in Murphy Oil Company v. Burnet, supra, at page 307: 'Here an anticipated depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.*' * * * If the tax officer treats a bonus payment as income, he must deplete it 27½ per cent under the command of the statute." (R. 45.)

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*"Percentage" depletion, first introduced in the 1926 Revenue Act, is unique in that the total allowances to be made over the life of the property are not limited to any particular cost or basis. Under the alternate system in the 1926 law, and the only one in earlier acts since 1918, when the total allowances equalled the basis or cost, no more was allowable. "Percentage" depletion allowances are unlimited in that respect. It is therefore impossible to make up for the denial of the allowance on a bonus in a later year.

§Regulations 69, Art. 216(a) supra.

The question should be considered in the light of well-known practical facts. Among these are the following:

It is most unusual for an oil and gas lease to be made on a tract of land already producing. Such leases ordinarily are the means by which the landowner secures the exploration of his property for oil or gas, and its discovery, as well as its development and exploitation. It is the custom for "ordinary royalties" to be the same in any territory, regardless of differences in the prospect of securing oil or gas on various tracts. This difference is ordinarily adjusted in commercial transactions by the amount of the advance royalty or bonus. Cf. Work v. Mosier, 261 U. S. 352.

The Treasury Regulations which, from 1918 to 1926, have expressly provided for depletion with respect to bonuses or advance royalties (See Murphy Oil Company v. Burnet, supra) never made any distinction whatsoever because one property might be producing when leased and another undeveloped, or because production might be secured in the year the lease was made on one and not until later on another. But these practical facts must have been known to the authors of these Regulations.

It is equally well known that, in the case of most oil and gas leases, (including those involved in this case), the lessor cannot control the time development is begun. It can ordinarily be delayed by the payment of nominal rentals, during the entire primary term of the lease. Likewise, the length of time for drilling a well varies, because of depth and geological conditions, from a few days to several months.

Therefore, a regulation which is to be applied only in the most unusual case (i.e., in the case of the leasing of a property already producing), when that limitation is not plainly expressed, is, at best, a sorry practical joke played on taxpayers and Congress. A regulation which would grant an allowance for depletion equal to 27½ per cent of over $680,000. of advance royalties, if one or two hundred bar-

rels of oil, worth, perhaps, $100.00 or $200.00 had been produced in the year of leasing, and deny the allowance if no production is secured until the next year, is arbitrary and capricious. The same is true of a regulation which would grant the allowance if one lessor grants his lease early in his tax year so that a well can be, and is, completed within that year, but denies it to a neighbor similarly situated, who leases so late in the year that his equally diligent lessee cannot secure actual production until the next year. The Court is referred to the dissenting opinion below (R. 42) as well as the dissenting opinion in the Glide case, 27 B.T.A. 1264, for a more extended discussion of such inconsistencies. For convenience these dissenting opinions are presented in full in the appendix to this petition at pages 18 and 22, respectively.

Plainly, we submit, the decision below conflicts with the express holding of this Court in *Murphy Oil Company* v. *Burnet, supra,* and *Burnet* v. *Harmel, supra,* as well as the basic principles underlying the statutory provisions as announced by this Court in *Palmer* v. *Bender,* supra, and *Helvering* v. *Falk,* 291 U. S. 183.

2. The case involves an important phase of Federal Income Tax Law, which enters into the determination of innumerable pending and future tax cases. It is present in almost every case where an advance royalty or bonus is paid for an oil and gas lease. Administrative practice has been unsettled by the decision below and other rulings, chiefly administrative. A decision by this Court will prevent much litigation and will expedite the closing of numerous tax cases.

It was the administrative practice, prior to the decision of the Board of Tax Appeals in *Murphy Oil Company,* 15 B.T.A. 1195, to allow depletion on bonuses or advance royalties whether the property leased was producing when

leased, or not, and whether or not any oil or gas was produced thereafter in the tax year.*

In that case, the Board took the position that no depletion allowance could be made as to the advance royalty or bonus, even when the property was producing when leased and continued to do so, thus holding directly opposite to administrative practice.

The contention that such bonuses should be taxed as capital gain (denied by the Bureau of Internal Revenue and the Board but upheld by the Fifth Circuit in the Ferguson case, 45 Fed. (2d) 573, and the Harmel case, 56 Fed. (2d) 153 caused further confusion until this Court decided the Harmel case. Shortly thereafter this Court decided the Murphy Oil Company case.

The Bureau of Internal Revenue, endeavoring to follow, in part at least, this Court's ruling in the Murphy case, promulgated G.C.M. 11384 on January 16, 1933 (Internal Revenue Bulletin XII-3) which recognized the lessor's right to percentage depletion on an advance royalty in some cases where the property was not producing when leased, and did not produce during the year in which the advance royalty was received, provided future production was "practically assured," but denied it in those cases in which the property leased did not have more than a "speculative prospect of future oil production" at the time the lease was made and did not actually produce until a later year. (This G.C.M. is copied in full in the appendix at page 24.

The difficulities of administration of G.C.M. 11384 are immediately apparent. Taxpayers would be compelled to employ expensive experts to prove to the Government experts that when the leases were signed production was

*Except that the Bureau had, in one ruling, held that "percentage" depletion could not be allowed on an advance royalty, unless the property was actually producing at the time the lease was made. This was based on the statutory phrase "in the case of oil or gas wells * * * a reasonable allowance for depletion, etc." although this phrase was identical with that in earlier acts under which the allowance was made regardless of that factor, and although the Bureau continued to allow depletion, other than percentage depletion, in the absence of production at the date of lease.

"practically assured" and disprove that there was "not more than a speculative prospect of future production." One of the principal reasons for the adoption, in the 1926 Act, of percentage depletion in lieu of discovery depletion, was to avoid such battles of experts.

The Board of Tax Appeals, on April 26, 1933, added to the confusion by deciding *Lizzie H. Glide,* 27 B.T.A. 1264 (now pending before the Ninth Circuit). The Glide decision disregarded G.C.M. 11384 and followed the Board's previous, and repudiated, reasoning of the Murphy Oil Co. case stating (p. 1267):

> "Depletion is inseparably related to production; it denotes a consumption of the reserve by means of which income is realized, resulting in a corresponding diminution of the value of the remainder of the asset. Unless there is production, neither the quantity nor value of the recoverable asset is depleted and there is no occasion for an allowance therefor."

The dissenting opinion of Board Member Van Fossan, Lansdon and Leech concurring, in the Glide case, is printed in the appendix to this petition at page 22.

These various and conflicting views render it impossible for administrative officers, or lower courts, to apply the law uniformly and tend to delay the settlement of all cases in which the question is involved until it is finally passed upon by this Court.

ERRATUM

Since the preparation of the petition in this case counsel has been informed of the decision of the Board of Tax Appeals promulgated June 29, 1934, in the case of J. T. Sneed, Jr., 30 B.T.A. Advance Sheet No. 171, which disapproves the Treasury Department's G.C.M. 11384. It clearly illustrates the divergent views of the members of the Board of Tax Appeals and the conflict between the majority of the Board and the Bureau of Internal Revenue.

In that case oil and gas leases were made on a large ranch in 1925 and 1926. Substantial advance royalties had been secured. In prior years a gas well had been drilled, but it did not produce commercially until later years because of lack of pipe line facilities. No wells were completed in 1925 or 1926, but at the date of trial fifteen or twenty wells were producing.

The majority held that:

> "* * * Without a detailed recital of the evidence, we have found as a fact that petitioner's lands in 1925 were regarded as proven oil or gas territory. The testimony of a qualified geologist, familiar with petitioner's lands and the field in which they are situate, the charts introduced showing existing wells in adjacent territory, and the fact that gas was found on petitioner's lands convince us that future production from wells which might be drilled on those lands was practically assured in 1925. That finding brings the case squarely within one of the situations described by respondent in G.C.M. 11384, C.B. XII-1, p. 64, in which he would permit the deduction of an allowance for depletion from income received as bonuses on leases, his description being as follows: '(1) No oil being produced when the bonus was received, but future production practically assured because of nearby wells and geological indications.'
>
> "We decline to follow this view and therefore disapprove the above quoted portion of respondent's ruling."

The dissenting opinion expressed the view that G.C.M. 11384 was valid; that it applied in the case; that the Bureau of Internal Revenue and the Board of Tax Appeals had theretofore not thought it necessary to have both production and income in the same year, and that the depletion claimed should be allowed. Judge Sibley's dissenting opinion in the case at bar was cited and commended.

Copies of the Sneed opinion are filed herewith for the Court's consideration.

Counsel is reliably informed that since the conflicting rulings mentioned have appeared the Bureau of Internal Revenue has concluded that no depletion deductions should be allowed on advance royalties (in the absence of production in the same year the bonuses were received) until the decision in the case at bar becomes final.

UNITED STATES BOARD OF TAX APPEALS

J. T. SNEED, JR., PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 45694. Promulgated June 29, 1934.

1. Prior to his marriage petitioner's brother conveyed to him an interest in their father's estate, and thereafter petitioner asserted claim thereto in partition proceedings and upon distribution of the estate received certain real estate. But conveyance was made to petitioner under agreement that the lands were not to be his until he paid for them; that, until petitioner made payment, the brother might convey to another; and that the purpose of the conveyance was to put title in petitioner so that a loan could be obtained on the property and the brother's debts discharged. Thereafter, petitioner was married, and later obtained a loan on this and his own properties and paid his brother the agreed price. *Held*, the purchase was made after petitioner's marriage, and, under the laws of Texas the lands were community property.

2. Bonuses received in connection with oil and gas leases upon petitioner's separate property are his separate income.

3. Delay rentals received in connection with oil and gas leases are community income whether lands under lease were separate or community property.

4. In the absence of a producing well on property, allowance for depletion of lease bonuses denied, even though future production of properties under lease was practically assured. G. C. M. 11384 rejected; *Lizzie H. Glide*, 27 B.T.A. 1264, followed and extended.

5. Petitioner submitted to revenue agent in charge (Dallas, Texas) a signed consent to extension of statutory period for assessment of tax for 1925, but wrote in a limitation as to amount of tax. The agent notified petitioner that this limited consent was not acceptable and demanded an unmodified consent, which petitioner refused to supply. Except for a statement in the notice of deficiency, issued after the expiration of the period, stating that consent was on file, the record discloses no other action by respondent respecting the consent, and no writing evidencing his acceptance of it before the time expired. Petitioner submitted no consent after expiration of statutory period. *Held*, the modified consent relied upon by respondent is ineffective, and assessment of the deficiency determined for 1925 is barred by statute.

Harry C. Weeks, Esq., Charles F. Koeffer, Esq., and Walter G. Russell, Esq., for the petitioner.

Frank B. Schlosser, Esq., and B. B. Cannon, Esq., for the respondent.

In assailing respondent's determinations of deficiencies in income tax for 1925 and 1926 in the respective amounts of $1,168.21 and $27,917.64, petitioner contends, first, that all the lands acquired by him subsequent to his marriage are community property; second, that an interest in his father's estate was acquired by petitioner from his brother after marriage and is community property; third, that delay rentals and bonuses received in connection with oil and gas leases upon his lands were community income, whether the lands were community or separate property; and, fourth, that the amount of the delay rentals and bonuses to be included in his income should be reduced by the deduction of an allowance for depletion. With respect to the deficiency for 1925, he further contends that its collection is barred by the statute of limitations, for the reason that the consent extending the statutory period upon which respondent relies is invalid.

FINDINGS OF FACT.

Petitioner is a resident of Amarillo, Texas. He was married on June 30, 1913, and has continuously been a resident of Texas since that date. All of the income here involved was reported as community income, divided one half to each in separate returns filed by petitioner and his wife for the years here before us. His father died in March 1912. For some years prior to that date, petitioner was engaged as a partner, first with his brother, and later with his father, who bought out the brother's interest, in a partnership operating in the ranching and cattle business.

Petitioner owns a ranch of about 85,000 acres in Moore County, Texas, and various tracts of these lands are embraced in oil and gas leases granted by him during the years now before us. A part of petitioner's holdings was purchased by him prior to his marriage; additional acreage was conveyed to him in the partition of his father's estate under decree of July 28, 1913; the remainder he acquired by purchases subsequent to his marriage, the deeds thereto being in evidence as Exhibits 8 to 11, inclusive. We adopt by reference as a part of our findings, Exhibits 1 and 2, which disclose, among other things, the source and date of acquisition of the various portions of the ranch embracing oil and gas leases later granted. Only as to the leased tracts is the time of acquisition material in this controversy.

Respecting the lands acquired by petitioner upon the partition of his father's estate, we find that for some years prior to March 1912, when his father died, petitioner was engaged with him as an equal partner in the ranching and cattle business. The partnership owned a ranch of about 77,000 acres, in which a one-half interest

belonged to petitioner upon the dissolution of the partnership by the death of the father. Petitioner inherited a one-seventh interest in his father's estate, or a one-fourteenth interest in the partnership lands. Petitioner's brother, J. B. Sneed, inherited a like interest. About this time, the latter was in serious difficulty and heavily in debt. On some of his indebtedness petitioner and other relatives were secondarily liable. By deed dated June 7, 1913, recorded on June 18, 1913, acknowledging receipt of a cash consideration of $50,000, J. B. Sneed conveyed to petitioner a one-seventh undivided interest in the lands formerly owned by the partnership. (The record does not explain why J. B. Sneed purported to convey a greater interest than he had, which both parties agree upon brief was a one-seventh undivided interest in the father's estate.) The consideration recited was not in fact paid at that time. Between the brothers, it was understood that the conveyance was made for purposes of accommodation; to pass title to petitioner that he might obtain a loan secured by his lands, and with the proceeds make payment of the purchase price to J. B. Sneed, who, in turn, would then discharge his indebtedness upon which petitioner and other members of the family were secondarily liable. It was further understood between the brothers that petitioner was not to have the land unless he paid for it; that if he failed to raise the funds by which to make payment, he was to reconvey to J. B. Sneed; that the latter was free to seek another purchaser for the property in the meantime, and that petitioner would convey to that purchaser should such a sale be arranged before petitioner had paid the recited consideration. The agreement between petitioner and his brother was entirely oral.

On July 29, 1913, a decree was entered in the suit between the Sneed heirs pending in the District Court of Moore County, partitioning the lands owned by the former partnership. In those proceedings petitioner claimed as his own the interest of his brother, to which he held title, and, accordingly, that interest was included along with petitioner's partnership interest and his own inheritance in the lands vested in him, which totaled 55,847 acres (after an adjustment to the other heirs for their shortages of some 326 acres). In November 1913 petitioner borrowed $120,000, secured by deed of trust, in which Mrs. Sneed joined, upon all his lands, including the acreage received in the partition, and from these funds made payment to his brother of $50,000.

During 1925 and 1926 petitioner granted about fifty oil and gas leases covering various portions of his ranch lands. The leases were in the form and upon the terms generally used in that field, most of them carrying provisions for bonuses and delay rentals. During

these years petitioner devoted about three fourths of his time to conferences with prospective lessees and other matters incident to the granting of the leases, most of which were negotiated through a broker.

In 1925 petitioner received bonuses of $10,400 and delay rentals of $10,364, a total of $20,764, of which respondent has treated $20,164 as separate income and the balance, $600, as community income. In 1926 he received bonuses of $210,857.18, and delay rentals of $26,605.11, a total of $237,462.29, of which respondent has treated $180,218.29 as separate income and the balance, $57,244, as community income. Expenses in connection with the making of the leases aggregated $559 in 1925 and $23,860 in 1926. These amounts were allowed by respondent as deductions from income, divided between separate and community income in the same ratio as he divided the bonuses and rentals. No dispute exists respecting the amounts received as bonuses and rentals, nor as to the amount of the expenses, the whole controversy being as to the status of the income, whether community or separate, and the allocation of the expenses between the two estates. Exhibits 1 and 2, previously mentioned, show in detail the leases from which the bonuses and rentals arose. The income arising from leases of lands owned by petitioner prior to his marriage, from leases upon lands acquired by him in the partition of his father's estate (including the acreage representing the interest purchased from J. B. Sneed), and a part of the income arising from leases of lands purchased by him after marriage, respondent has treated as separate income.

In 1922 a gas well was brought in on a lease previously granted embracing a tract nearly in the center of petitioner's lands. While the well was capable of producing (though whether in paying commercial quantities we do not know), no gas was removed during the years 1925 and 1926, for no pipe line was laid until after that time. In 1925 the whole of petitioner's ranch was regarded as proven oil or gas territory, probably productive of oil or gas, or both.

Petitioner's return for the year 1925 was filed on May 14, 1926. Respondent's notice of deficiency was issued on July 18, 1929. In January 1929, the revenue agent in charge at Dallas, Texas, transmitted to petitioner the usual form of consent extending the statutory period for assessment of tax for the year 1925, requesting its execution and return. Petitioner complied with that request under date of January 5, 1929, but wrote into the consent as a limitation upon the amount of deficiency, "not exceeding the sum of $1,168.21." Thereafter, on January 10, 1929, the revenue agent wrote petitioner in part as follows:

You are advised that the waiver form as modified is not acceptable to this office, therefore, unless the taxpayer desires to submit an unqualified waiver extending the period within which an additional assessment may be made for the year 1925 to December 31, 1929, it will be necessary to transmit Agent Dubb's report to Washington for review and assessment at an early date.

* * * * * * *

Unless the enclosed waiver forms properly executed are received in this office within 10 days from the date of this letter it will be necessary to transmit the case to the Bureau at Washington for review and assessment.

Petitioner refused to execute and submit an unqualified consent. The revenue agent in charge transmitted the case to the Bureau at Washington. Respondent's notice of deficiency contains the following statement: "Consent is on file for the year 1925 extending the statutory period of limitations to December 31, 1929." Exhibit 13, submitted in evidence as a copy of the limited consent of January 5, 1929, bears the signature of petitioner but not that of respondent. Petitioner's return for the year 1925 was filed on May 14, 1926.

OPINION.

GOODRICH: It is admitted that under the Texas statutes [1] the lands purchased by petitioner prior to his marriage, his interest in the partnership lands which he owned prior to marriage, and the lands representing his interest in his father's estate were his separate property. It is clear also, and respondent inferentially admits it, that the lands purchased by petitioner subsequent to his marriage are community property. Since the record (Exhibits 1 and 2) discloses the source and date of acquisition of all the tracts under lease (and we are here concerned only with the leased lands), the classification of the lands, the income arising therefrom, and the allocation of the expenses are a simple matter, except for the property representing the interest purchased from J. B. Sneed. The time of that purchase is in controversy. Respondent determined and maintains that it was effected prior to petitioner's marriage; petitioner contends it was effected thereafter.

We are of opinion that the interest was not purchased by petitioner until subsequent to his marriage and therefore that the lands were community property. True, ostensibly this interest was conveyed to petitioner by deed of June 7, 1913, which was a short time prior to his marriage (June 30, 1913) and was claimed by him in the partition proceedings as a part of his share of his father's estate. If petitioner's ownership in the property had its inception when the deed was executed, the lands conveyed became and thereafter re-

[1] Texas Civil Statutes (1914), arts. 4621, 4622; Texas Civil Statutes (Revision 1925), arts. 4613, 4614, 4619.

mained his separate property, for the Texas rule is that the date of inception of ownership fixes the status of the property.[2] Petitioner does not question that rule, but contends that under the facts in this case his ownership did not have its inception in the passing of the deed before his marriage, but in the payment of the money thereafter. With that we agree.

The testimony is uncontradicted and convincing that the transfer of the legal title to petitioner was for the accommodation of the transferor; that the purpose was to enable petitioner to raise money by a loan, secured by him upon these lands, with which to enable J. B. Sneed to discharge the indebtedness upon which petitioner and other relatives were secondarily liable. It was with that understanding between the brothers that petitioner claimed the interest in the partition suit. As we view it, this is not a case where a bona fide conveyance is made effecting a completed sale, with payment of the consideration deferred. Petitioner was not obligated to buy the land, nor was it to be his until he paid for it. He had no option to buy, for J. B. Sneed was free. until petitioner should pay him the agreed price, to sell to any purchaser he could find. As between the parties the conveyance was not final, but conditional, and petitioner held only as trustee for security and convenience. We doubt whether the conveyance under such circumstances could have withstood an attack by creditors or other interested parties, and it is well settled that property conveyed upon trust, in which neither husband nor wife has any beneficial interest, is not community property.[3]

We conclude that no sale of the J. B. Sneed interest to petitioner was accomplished until after petitioner's marriage, when he obtained a loan and paid for the interest of his brother in the father's estate. The lands received by petitioner upon partition of that estate, totaling 55,847 acres, represented nine-fourteenths of the total acreage owned by the partnership; seven-fourteenths being petitioner's interest as a partner, one-fourteenth being his interest as an heir, and one-fourteenth being the interest he purchased from his brother (although the deed recited the brother's interest as one-seventh of the whole of the partnership lands). The lands representing the purchased interest in the estate should be classified as community property.

[2] See Speer's Law of Marital Rights in Texas, 3d ed., p. 1051; note from 17 L.R.A. (U.S.) 154 appended to decision in *Creamer* v. *Briscoe*, 101 Tex. 490 (109 S.W. 911). See also, for discussion of applicable principles, *John M. King*, 26 B.T.A. 1158; affd. 69 Fed. (2d) 639.

[3] See Speer, Law of Marital Rights in Texas, ¶ 357, p. 488; *Crenshaw* v. *Harris*, 41 S.W. 391.

We come, then, to a consideration of the controversy respecting the classification, for purposes of the tax, of the income arising from the property under the leases—the delay rentals and bonuses. Petitioner vigorously contends that these revenues are community income and should be so taxed, no matter whether the leases embraced separate or community lands. As to the bonuses, this contention heretofore has been resolved against him, for it has been determined that cash considerations paid for the execution of leases upon separate property are the separate income of the owner of the property. *James R. Parkey*, 16 B.T.A. 441; *John O'Neil*, 16 B.T.A. 614; *W. P. Ferguson*, 20 B.T.A. 130; affirmed as to this issue, 45 Fed. (2d) 578; *Oscar Chesson*, 22 B.T.A. 818 (petition for review denied, 57 Fed. (2d) 141); *E. Michna*, 24 B.T.A. 715. We are not persuaded to a deviation from this rule of decision by petitioner's argument that the character of the bonus income was changed by reason of the fact that much of his time and attention was given to the negotiation of the leases (the majority of which were consummated through brokers). See *No. 1 Oil Corp.* v. *Bass*, 283 U.S. 279; *Rose* v. *Houston*, 11 Tex. 324; *Arnold* v. *Leonard*, 114 Tex. 535; *Stephens* v. *Stephens*, 292 S.W. 291. The bonuses received should be taxed as separate or community income in accordance with the classification of the properties under lease, covered by the various leases as shown by Exhibits 1 and 2, upon which the bonuses were paid. This allocation may be made upon settlement of the case. But it is held also that no distinction exists between delay rentals arising under leases and ordinary rentals of farm lands, and that the latter are income of the marital community, notwithstanding that the lands from which they arise may be the separate property of either spouse. G.C.M. 11197, C.B. XII–1, p. 238; *John O'Neil*, *supra*, citing *Willcutt* v. *Willcutt*, 278 S.W. 236; *Caruthers* v. *Leonard*, 254 S.W. 779. Therefore, the delay rentals received during 1925 and 1926 should be taxed as community income.

Petitioner's claim for the deduction from income of an allowance for depletion of 27½ percent of the income from the properties (delay rentals and bonuses) is also controlled by prior decision. In *Lizzie H. Glide*, 27 B.T.A. 1264 (on review C.C.A., 9th Cir.), we held that depletion is inseparably related to production; that unless there is production, no depletion of reserve is in fact sustained, and no allowance therefor may be made. Here there was no production from any of the leased properties during the years before us. There was a well upon one lease it is true, but it was shut in and no gas was removed. A closed well does not produce; it does not exhaust the reserve; its mere existence does not set up production

inseparable from depletion, nor serve to exempt the case at bar from application of the effect of the *Glide* case.

But this case goes further on its facts. Without a detailed recital of the evidence, we have found as a fact that petitioner's lands in 1925 were regarded as proven oil or gas territory. The testimony of a qualified geologist, familiar with petitioner's lands and the field in which they are situate, the charts introduced showing existing wells in adjacent territory, and the fact that gas was found on petitioner's lands convince us that future production from wells which might be drilled on those lands was practically assured in 1925. That finding brings the case squarely within one of the situations described by respondent in G.C.M. 11384, C.B. XII–1, p. 64, in which he would permit the deduction of an allowance for depletion from income received as bonuses on leases, his description being as follows: "(1) No oil being produced when the bonus was received, but future production practically assured because of near-by wells and geological indications."

We decline to follow this view, and therefore disapprove the above quoted portion of respondent's ruling.

If we are correct in holding that without production there is no depletion (which, in fact, cannot be denied) and that without actual depletion there may be no allowance therefor, the probability of production from a property in the future is immaterial. Unless that production is obtained within the same taxable period in which the bonus is received, the latter must be carried into income unreduced by an allowance for depletion. We are fully cognizant of the possibility, which petitioner on brief points out, that cash considerations received in connection with the granting of leases in one year perhaps may never be reduced by a depletion allowance because production was not obtained until a later taxable period. If that situation is to be corrected, the task is for the Congress, not for respondent, nor for this Board or the courts to attempt by a straining of the plain provisions of the statute. See *Aubrey Umsted*, 28 B.T.A. 176. We conclude that petitioner may not deduct any allowance for depletion in either 1925 or 1926. This result is amply supported by the decision of the Circuit Court of Appeals for the Fifth Circuit in *Herring* v. *Commissioner*, —— Fed. (2d) —— (Apr. 24, 1934), which affirmed our memorandum decisions in Dockets 47041 and 47042 (June 29, 1933), wherein we followed the *Glide* case, *supra*.

The remaining issue relates to the validity of the consent upon which respondent apparently relied in issuing his notice of the deficiency for 1925 after the time within which, without an exten-

sion by mutual consent in writing, the assessment thereof would be barred by statute. Petitioner contends that there is no consent; that the qualified consent which he submitted was rejected by respondent.

We agree with him. The rejection of petitioner's modified consent by the revenue agent in charge, who represented and acted for respondent, was definite and unequivocal. There is no evidence before us to indicate that respondent, within the statutory period, disapproved of his agent's refusal of the offered consent or took any action evidencing a reconsideration of the refusal and a consequent acceptance of and reliance upon the consent. Nor does the record show that petitioner asked for or received any benefits by reason of his offer to agree to a waiver of the statutory period. On the contrary, his refusal to comply with respondent's demand to submit a second consent in form acceptable to respondent shows clearly that petitioner was willing that respondent proceed at once to a final determination of deficiency in the case, and to the assessment thereof unless stayed by petition to the Board, within the period allowed by law. Therefore, the consent form signed and offered by petitioner and rejected by respondent was of no effect, and prior to the expiration of the statutory period there was no agreement in writing between the parties for an extension of that period. See *American Railways Co.*, 30 B.T.A. (No. 147).

Moreover, even had respondent's rejection of the offered consent been less definite, there would still be no agreement in form prescribed by statute, for respondent has failed to sign the consent in evidence of his agreement thereto. We understand the rule to be that a consent is ineffective unless signed by or on behalf of the Commissioner, *Chadbourne & Moore*, 16 B.T.A. 961; *Melville W. Thompson*, 18 B.T.A. 1192; *Corn Products Refining Co.*, 22 B.T.A. 605; *Atlantic Mills, etc.* v. *United States*, 3 Fed. Supp. 699; *U. S. Refractories Corp.*, 23 B.T.A. 872; affd., 64 Fed. (2d) 69; 290 U.S. 591; (*contra*, *Commissioner* v. *Hind*, 52 Fed. (2d) 1075; reversing 18 B.T.A. 96; *Parker* v. *Commissioner*, 49 Fed. (2d) 254)—unless the Commissioner's written approval of the consent appears elsewhere or can be reasonably inferred. *Stearns Co.* v. *United States*, 291 U.S. 54.

Here, the consent is not signed by or for respondent, and his only writing which could possibly record his approval or from which his approval could possibly be inferred, is the deficiency notice issued on July 18, 1929, after the statutory period had expired. Consequently, it cannot be said that before the period expired the parties had consented in writing to an extension of the time. Nor can it be said that both consented in writing *after* the time prescribed as permitted by

section 278 (c), 1924 Act, for petitioner submitted no consent except that of January 5, 1929. Respondent's notice of a deficiency for the year 1925 came too late.

Reviewed by the Board.

Judgment will be entered under Rule 50.

ARUNDELL, dissenting: For the reasons so ably set forth by Judge Sibley in *Herring* v. *Commissioner*, — Fed. (2d) — (Apr. 24, 1934), I disagree with the majority opinion in this case in disallowing depletion to taxpayer. Under the practice of the Bureau of Internal Revenue and the decisions of the Board, depletion allowances are treated as more intimately connected with income from the property than with actual production. That is, it has not been thought necessary to have both production and income in the same year in order for depletion deductions to be allowable. See *Clearfield Lumber Co.*, 3 B.T.A. 1282; *R. M. Waggoner*, 5 B.T.A. 1191; *Inspiration Consolidated Copper Co.*, 11 B.T.A. 1425; A.R.M. 12, C.B. 2, p. 144. While the rule of those cases perhaps should not be extended to situations where there is no production within a reasonable time after payment of a bonus, the Commissioner has interpreted the statute to apply to cases where production is practically assured. G.C.M. 11384, C.B. XII–1, p. 64. This ruling, promulgated after *Murphy Oil Co.* v. *Burnet*, 287 U.S. 299, is designed to give the reasonable allowance required by the statute. The facts in this case show that production was practically assured, and it also appears in the record, though not found as a fact, that fifteen or twenty wells have since been drilled, all producing or capable of production. I think the Commissioner's ruling to be sound, and as it concededly applies to this case it is error to deny deductions for depletion against the bonuses.

LEECH agrees with this dissent.

CONCLUSION

For the reasons stated the writs should issue.

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July 14, 1934.

APPENDIX

Dissenting Opinion of Judge Sibley in Herring Case

"SIBLEY, Circuit Judge, Dissenting:

"The question is whether a percentage depletion is allowable on bonuses received in 1926 for oil and gas leases which are to endure so long as oil or gas is produced when no well was drilled and no oil produced under them during that year, although the oil and gas were present and were produced later. The Board of Tax Appeals denied the allowance because there was no well, and this court denies it because no oil was taken out. One of the pertinent provisions of the Revenue Act of 1926, 'In computing net income there shall be allowed a deduction . . . in the case of mines, oil and gas wells, and other mineral deposits and timber, a reasonable allowance for depletion and for depreciation of improvements according to the peculiar conditions in each case,' occurred in previous acts. The other provision: 'In case of oil and gas wells the allowance for depletion shall be 27½ percentum of the gross income from the property during the taxable year,' is new. Great difficulty was found under the former provision in estimating the content of an oil and gas reserve under the ground and in arriving at what proportion of it was represented by the operations of a particular taxable year, and also in fixing the value of the reserve under the rules relating to discovery value. To avoid these difficulties Congress in the new provision ignored both the size and the value of the reserve, assumed that the value of any production of oil or gas would on the average be 27½ percent original capital investment not to be taxed, and the remaining 62½ percent would be taxable income, and provided for its taxation in the year it was received. It is evident that the 27½ percent deduction which the statute not only permits but commands must be made in the year that the income which measures it is received and taxed, that it cannot be taken any subsequent year, and that it is entirely independent of actual deple-

tion, being so named because it looks forward or backward to the exhaustion represented by the income received. The purpose and command of the provision is defeated by the decision in this case. The oil and gas were present to be produced, as was of course supposed when nearly a half-million dollars were paid in advance for them as bonuses, and as was proven when the wells were drilled. That the lessees by their own choice not to drill the first year should control the taxability of the lessor's bonuses, or that the depletion allowance on the entire bonuses should depend on the production in the taxable year of a few gallons of oil or a few feet of gas seems to me both unreasonable under the general provision for depletion and in contradiction of the special provision for the percentage deduction.

"It is true that depletion, like depreciation because of wear and tear and obsolescence, is based on the actual gradual loss of capital. The allowance for wear and tear and obsolescence is, however, always estimated and distributed over the useful life of the property considered, and does not depend on a demonstration of what actually happened to it in the particular taxable year. The allowance for them is a general offset against all income for the taxable year rather than a deduction from some particular item of income, because wear and tear and obsolescence, although a loss of capital, do not directly produce any particular income. Depletion also may sometimes be a mere loss, as when oil or gas runs to waste or standing timber dies and rots. But ordinarily depletion refers to a commercial use of part of a reserved store, as where ore or gas or oil is extracted for sale, or timber or ore or oil is manufactured into lumber or metal or gasoline and sold. In such cases the capital represented by the depletion is used directly to produce income and is converted into it. According to *Eisner* v. *McComber,* 252 U. S. 189, only gain is taxable income under the Sixteenth Amendment where a conversion of property is involved. Congress is

therefore merely staying on safe constitutional ground in providing for this percentage depletion against income received from oil and gas. If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his receipt of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timber, he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil expected to be recovered by the lessee. Both are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. *Burnett* v. *Harmel,* 287 U. S. 103; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Bankers Coal Co.* v. *Burnet,* 287 U. S. 309; *Palmer* v. *Bender,* 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been

that a *reasonable* allowance shall be made *according to the peculiar conditions of each case.* Construing it as to a bonus, it is said in *Murphy Oil Co.* v. *Burnet, supra,* at page 307: 'Here an *anticipated* depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.* The allocation is permitted by statute.' This language is quite at variance with that of the court below quoted in the majority opinion. When this provision was first enacted in 1918, Regulation 45, Art. 215 (d), provided that on the expiration or abandonment of a lease *without the removal* of any or all of the mineral contemplated by the lease, there must a return to capital account of so much of the *bonus* deducted from the recoverable capital as *exceeds actual depletion,* and that amount must be treated as income the year the lease was ended. This shows that it was understood that the bonus payment was considered depletable in advance of actual depletion, and that if the contemplated depletion does not occur the correction is to be made at the end of the lease. The same Regulation has been continued ever since, as Congress has reenacted the same depletion provision, and it is referred to and its operation approved in *Murphy Oil Co.* v. *Burnet,* supra, at page 304, and again at page 306. The statutory words: 'In case of oil and gas wells' are directly connected with 'or other mineral deposits.' Wells as such were not in the mind of Congress as subjects of depletion, but the deposits of oil and gas and other minerals were in mind, and as shown above, depletion of bonuses on leases was regularly allowed although in most cases, no doubt, actual production is not accmplished in the year the lease is made. When in the Act of 1926 Congress again used the expression, 'In case of oil and gas wells' in connection with the percentage depletion no narrower meaning is to be attributed to it. *United States v. Dakota-Montana Oil Co.,* 288

U. S. 459. On the contrary, even more plainly the receipt of income and not the existence of a well or of production from it is made the generating cause of the depletion allowance. If the tax officer treats a bonus payment as income, he must deplete it 27½ percent under the command of the statute.

"In *Helvering* v. *Falk* .... U. S. ...., depletion under all the Acts through that of 1926 was under consideration and the cases were reviewed with this conclusion: 'Whatever may be said concerning the power of Congress to treat the entire proceeds of a mine as income, obviously the statute has not undertaken to do so. The plain purpose we think was to tax only that portion of the proceeds remaining after proper allowance for depletion. This allowance represents property consumed, is treated as if capital assets, and no tax is laid upon it. The statute must be so applied in practice as to carry out this purpose.' The judgment in the case at bar defeats the statutory purpose and by denying the allowance which the statute commands taxes that part of the money received which ought to be treated as if capital assets."

Dissenting Opinion in Lizzie H. Glide Case

"VAN FOSSAN, dissenting: I find it necessary to dissent from the decision of the majority. In considering the right of a taxpayer to depletion, I am unwilling to decide the question on any basis so highly technical and artificial as that employed in the prevailing opinion. Under the reasoning of the majority, the right to depletion depends on the existence of a well on the property. Obviously the production of the well, provided there be a well, need bear no relation to the amount of depletion. The law allows a flat percentage of income from the property (not from the well) as depletion. The Supreme Court has held that a bonus is income. Therefore if the bonus be paid and there happens to be a well in existence (however inconsequential the pro-

duction) the taxpayer gets full statutory depletion. If there be no well, regardless of other conditions, the taxpayer gets no depletion. But assume a case where, as frequently happens, a bonus is paid in one year and there is no well completed until the next year. The taxpayer would get no depletion on account of the bonus (or advance royalties, as the Supreme Court has called them) because there was no well on the property though all surrounding property bore productive wells, nor would he get depletion of the bonus in the next year even if a producing well be completed, because the bonus was not income in that year. Variations of this illustration, emphasizing the absurdities of the situation, could easily be multiplied.

"I am unable to see any defensible basis for a distinction that would produce such an inequitable and illogical result. The prevailing opinion introduces a new concept into the theory of depletion and in many cases sets at naught the intention of Congress as interpreted by the decisions of the Supreme Court so far as depletion of bonuses is concerned. *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. The cited case clearly decides that a bonus is depletable and makes no suggestion that this right should be governed by such a rule as laid down by the majority. The court clearly suggests the opposite:

> "A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for *a reasonably anticipated production of oil* on the leased premises would deny the 'reasonable allowance for depeletion' which the statute provides. * * * (Italics supplied.)

"Moreover, I further find myself in disagreement with the majority opinion in the summary manner in which G.C.M 11384 is disposed of. That the Commissioner is not now contending for such a rule as proposed by the majority is clear from this memorandum, which provides that de-

pletion should be allowed if future production is practically assured because of nearby wells and geological indications. Whether this interpretation is too narrow it is not necessary to discuss, but certainly it is broad enough to cover the instant case. The facts show that oil was being produced in the same township and in the same oil field. This brings the petitioner squarely within the first of the four situations referred to in the memorandum. The prevailing opinion dismisses the matter on the basis of failure of proof.

"In my opinion the majority of the Board throughout this opinion have grasped at a shadow of diction and allowed the substance of the thought and intention of Congress and the Supreme Court to escape them.

"Lansdon and Leech agree with this dissent."

G. C. M. 11384

An opinion is requested relative to the application of the decision of the United States Supreme Court in the case of *Murphy Oil Co.* v. *Burnet,* December 5, 1932 (53 S. Ct., 161), to certain situations arising in connection with the allowance of percentage depletion in the case of a bonus paid for an oil or gas lease.

Although the United States Supreme Court had before it in the Murphy case a question which arose in connection with an allowance for depletion based on cost, some of the language used by the court appears to be equally applicable to certain situations arising in connection with percentage depletion. The language referred to is as follows:

> * * * when the execution of an oil and gas lease is *followed by production of oil,* the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Section 234. * * * A distinction between royalties and bonus * * * making no provision for a reasonably anticipated production of oil on the leased premises, would deny the *"reasonably anticipated production of oil"* on the

leased premises, would deny the "reasonable allowance for depletion" which the statute provides. * * * (Italics supplied.)

The four situations to which attention is called are as follows:

(1) No oil being produced when the bonus was received, but future production practically assured because of nearby wells and geological indications.

(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

(4) Property has never become productive.

It is stated in substance that it is the opinion of the Income Tax Unit that a practical application of the law and the regulations in the light of language used in the Murphy Oil Co. case would be to allow depletion in situations (1) and (2) and to deny it in situations (3) and (4).

After consideration of the question, this office is of the opinion that the conclusion reached by the unit is correct and should be applied in the disposition of future cases involving this issue.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1934.

WILLIAM E. HERRING AND EULA DAY HERRING,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

BRIEF FOR PETITIONERS.

Opinions Below.

The opinion of the Circuit Court of Appeals for the Fifth Circuit (Judge Sibley delivering a dissenting opinion) appears in the record on pages 37 to 46 and is reported in 70 F. (2d) 785. The opinion of the Board of Tax Appeals,

which was a memorandum opinion not officially reported, appears in the record at pages 13 and 14.

Jurisdiction.

The judgment of the Circuit Court of Appeals for the Fifth Circuit was entered April 24, 1934 (R. 46), petition for rehearing denied June 8, 1934 (R. 47), Writs of Certiorari were granted October 8, 1934. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented.

In computing net taxable income for 1926 are the petitioners entitled to deduct the statutory allowance for depletion from the advance royalties or "bonuses" received by them in 1926 upon the execution in that year of ordinary oil and gas leases? Or must they lose that allowance because the land leased was not producing oil or gas when the leases were made, and because the land did not produce oil or gas until after 1926?

Statutes and Regulations Involved.

Section 214(a) 1926 Revenue Act.

> "In computing net income there shall be allowed as deductions:
>
> * * * * * * * *
>
> (9)In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

Section 204(c) 1926 Revenue Act.

"The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

(1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Article 216, Regulations 69.

"*Depletion—Adjustments of accounts based on bonus or advanced royalty.*

"(a) [1] Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * * * *

"(c) [2] If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts

---

[1] Article 215(a) of Regulations 45 (1918 Act) read as follows:

"Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Treasury Decision 3938, promulgated November 13, 1926, Internal Revenue Bulletin V-2, page 117, changed subdivision (a) to read as follows:

"Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

Murphy Oil Co. v. Burnet, 287 U. S. 299, dealt with subdivision (a) as originally promulgated and as amended.

[2] All regulations beginning with those under the 1918 Act have contained provisions identical with subsections (c) and (d).

by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

"(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

"(e) [1] In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property."

Statement.

During the year 1926 the community estate of William E. Herring and his wife Eula Day Herring owned a 50 per cent interest in the partnership C. T. Herring & Son. For that year petitioner William E. Herring and his wife, petitioner Eula Day Herring, filed separate income tax returns under the community property laws of Texas. In 1926 the partnership owned a large tract of land in the vicinity of Amarillo, Texas, and its principal business was cattle raising. During 1926 the partnership leased portions of its land for the "sole and only purpose of mining and operat-

[1] This subsection was first introduced into the regulations under the 1926 Act, due to the option contained in that Act to compute oil and gas depletion by the "percentage" method.

ing for oil and gas," etc. These leases were in all respects the customary oil and gas leases (R. 30). The lessees paid in the aggregate to the partnership lessor, in 1926, $683,793.75 as advance royalties or bonuses and agreed to pay further royalties of 1/8th of the product, or its value, as oil or gas was actually produced under the leases.

The lessor had no control over the time wells would be drilled by the lessees. At the time the leases were executed and during the remainder of the year 1926 there was no oil or gas well on the land and no oil or gas was produced therefrom. However, in 1930 four wells were drilled, all of which were commercial gas wells, all had a showing of oil, and one produced from eight to ten barrels of oil a day.

In 1926, when the leases were executed, it was highly probable that the land would, when explored, produce oil or gas or both. This is shown in the record by the fact that wells comparatively close and on all sides of the property were producing; by uncontradicted expert testimony as to geological conditions and, perhaps more convincing to those who cannot qualify as technical oil and gas men, by the fact that the lessees, who were engaged in the oil and gas business, were willing to pay $683,793.75 for the privilege of exploring the property for oil and gas.

The partnership claimed its members were entitled to a deduction in 1926 on account of depletion in the aggregate amount of $188,043.28, which represented 27½ per cent of the advance royalties or bonus payments. Each of the present petitioners deducted from income on their income tax returns their proportionate share of the said depletion deduction claimed by the partnership. The Commissioner of Internal Revenue refused to allow the deduction on the ground that "the property on which depletion was claimed was neither proven nor producing during the year in question." The Board of Tax Appeals, in a memorandum opinion, affirmed the Commissioner on the authority of *Lizzie H. Glide*, 27 B. T. A. 1264, which held that there must be a well on the property before the lessor could be allowed the

depletion deduction. The Circuit Court of Appeals, Sibley, Circuit Judge, dissenting, affirmed the Board on the ground that there was no production on the property within the taxable year.

Specification of Errors to Be Urged.

1. The Court below erred in holding that advance royalties or bonuses are not subject to depletion.

2. The Court below erred in not holding that percentage depletion is based upon income, the allowance of which looks forward or backward to actual production.

3. The Court below erred in denying petitioners the reasonable allowance for depletion which the statute permits.

4. The Court below erred in affirming the Board of Tax Appeals.

Argument.

Decision should be for the petitioners for the following reasons:

1. The advance royalties are taxable income. *Burnet v. Harmel,* 287 U. S. 103; *Bankers Coal Co. v. Burnet,* 287 U. S. 309;

2. The advance royalties are not proceeds from the sale of property but payments in advance for oil and gas to be produced (*Murphy Oil Co. v. Burnet,* 287 U. S. 299; *Work v. Mosier,* 261 U. S. 352); therefore they come within the term "gross income from the property" as used in Sec. 204 (c) (2) of the Revenue Act of 1926—requiring that "percentage" depletion be allowed on such "gross income."

3. The right to the deduction is not defeated by the qualifying phrase "in the case of oil and gas wells". This phrase does not require either the existence of an oil or gas well when the lease is made, or later in the same year, nor production in that year. It is satisfied if, at any time

during the term of the lease, oil or gas is produced. This is so, because:

(a). This construction was placed upon the same language in prior Revenue Acts, and the language reenacted in the light of that construction. *United States v. Dakota-Montana Oil Co.,* 288 U. S. 459.

(b). Practice and rulings, under the same or similar language, permitted depletion with respect to advance royalties when no well was in existence during the year the lease was executed and the bonus was received, and when no oil or gas was produced in that year.

(c). This Court has expressly held that an allowance for depletion should be made with respect to advance royalties, and this without the qualifications which the Government now seeks to impose and uphold. *Murphy Oil Co. v. Burnet,* 287 U. S. 299.

(d). Treasury Regulations have, since 1918, provided for the recapture of all, or part, of such an allowance if the execution of the lease was not followed by actual production and exhaustion of the oil or gas content. This not only warrants the practice but prevents fiscal loss if no depletion is actually sustained.

(e). The allowance for "percentage depletion" is based upon receipt of income from the property in the tax year—not upon actual production and exhaustion in the tax year. Necessarily it must look forward or backward to actual production and exhaustion, but the requirement of contemporaneous production destroys the basic principle of percentage depletion.

(f). The theory of the Government in this case, and of the majority below, as well as the Board of Tax Appeals, is not the theory of the Treasury. This is expressed in G. C. M. 11384. It conflicts directly with the reasoning of the Government here. If G. C. M. 11384 is construed to deny Petitioners' claim, the result is so arbitrary and whimsical that even its more liberal theory must be enlarged to cover the situation herein presented.

In order to present a complete picture of the problem involved this brief presents a short history of the legislation allowing a deduction for depletion (p. 9), a discussion of the changes resulting from the adoption of percentage depletion in the case of oil and gas wells (p. 10) and a history of the taxation of advance royalties, or bonuses (p. 12).

History of legislation allowing a deduction for depletion.

The Excise Tax Act of 1909 (36 Stat. 11, 112) had no provision for depletion. Under that Act it was held that a deduction for depletion could not be taken as the right to such deduction is statutory. *Stratton's Independence v. Howbert,* 231 U. S. 399; *Von Baumbach v. Sargent Land Co.,* 242 U. S. 503; *United States v. Biwabik Mining Co.,* 247 U. S. 116.

The Act of October 3, 1913 (38 Stat. 114, 166-167—Section II) provided for the deduction "in the case of mines, five per centum of the gross income at the mine of the output for the year for which the computation is made, etc." The amount of the deduction was attacked on the ground it was inadequate. In *Stanton v. Baltic Mining Co.,* 240 U. S. 103, this Court sustained the right of Congress to put an arbitrary limit on the allowance.

The Revenue Act of 1916 (39 Stat. 756, 767) allowed: "In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production * * *; in the case of mines a reasonable allowance for depletion thereof * * *."

The same language was used in the Excess Profits Tax Act of 1917.

The Revenue Act of 1918 (40 Stat. 1057, 1077) allowed (Sec. 234 (a) (9)): "In the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion * * * according to the peculiar conditions in each case * * *". The section also pro-

vided for the computation of the deduction based on "discovery" instead of cost, when the value was materially disproportionate to cost.

The Revenue Acts of 1921 and 1924 contained exactly the same provisions regarding depletion except for certain limitations on "discovery" depletion which are not material here.

The Revenue Act of 1926 (which is applicable here) abolished discovery depletion for oil and gas properties and substituted percentage depletion therefor. Section 204 (c) provided that the basis for depletion should be the same as the basis for gain or loss from a sale, except that in the case of mines discovery value was still permitted, and:

> "(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

In other words, taxpayers owning interests in oil and gas properties could still choose between cost, or March 1, 1913 value, and percentage depletion, instead of between cost, or March 1, 1913 value, and discovery depletion.

The principal motive of Congress in making this change was to avoid the administrative difficulties of discovery depletion.[1]

The allowance of percentage depletion in the case of oil

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(1) The Finance Committee Report on the 1926 Act (Senate Report No. 52, 69th Congress, 1st Session) states at page 17:

> "The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends etc." To the same effect see "Statement of the Managers on the Part of the House" at page 31 of the Conference Report (House Report No. 356, 69th Congress 1st Session).

and gas wells has been continued in the 1928, 1932 and 1934 Revenue Acts.

Changes resulting from the adoption of percentage depletion.

The abandoning of discovery depletion and the substitution of percentage depletion resulted in two important changes regarding the depletion allowance. In the case of percentage depletion there is no limit to the amount of depletion which can be allowed with respect to any particular property. In other words, there is no basis which, when exhausted, stops the allowance. When depletion is based on cost, March 1, 1913 value, or discovery value, the deduction stops when it aggregates the basis. For example, if the basis is $100,000, whenever a taxpayer has been allowed depletion deductions in the aggregate amount of $100,000 he is entitled to no further allowance, even though the property may continue to produce for many years.

The other important change resulting from the adoption of percentage depletion is that the allowance for depletion is no longer related to, or dependent upon, the actual production from, or the exhaustion of, the property. This is clearly illustrated as follows:

In the case of depletion based upon cost, or other fixed basis, if ten per cent of the oil or gas reserve was extracted in a particular year the taxpayer must be allowed ten per cent of the basis. In the case of percentage depletion the allowance is entirely different.

In Texas in recent years oil has sold for $2.00 or more per barrel, and as low as ten cents per barrel. If in one year ten cents per barrel is paid for the production from a particular property and in another year $2.00 per barrel is paid for oil from the same property, it is apparent that the amount of the depletion allowance is twenty times more dependent upon the price of oil than it is upon the amount of oil produced. As percentage depletion is limited not

only by gross income, but by net income, the allowance, in actual practice, will vary more on account of price than the actual ratio of difference in the price.

For example, assume that the operating expense of a particular property is twenty-five cents a barrel. In one year the property produces 100,000 barrels of oil which was sold for $1. a barrel, or $100,000. As the operating expense was twenty-five cents a barrel the net income was $75,000. The taxpayer would thus be permitted to deduct $27,500 depletion, because that amount is 27½ per cent of the gross income and less than 50 per cent of the net income.

The next year the same property produced 100,000 barrels of oil, which sold for but 30 cents a barrel with the same operating cost, so there was a net income of $5,000. The depletion allowance would be but $2,500 because of the limitation that it should not exceed 50 per cent of the net income. Had the price of oil been 25 cents a barrel there would have been no net income and no allowance for depletion. In each of the cases mentioned the exhaustion of the oil reserves would be identical.

History of the taxation of advance royalties or bonuses.

The foregoing has been devoted to a history of depletion allowances generally. We now direct ourselves to the history of the treatment of advance royalties, or bonuses, received for executing oil and gas leases.

In dealing with cost depletion the Commissioner of Internal Revenue has, since 1918, held that advance royalties, or bonus payments, are subject to depletion. As originally issued Article 215 (a) of Regulations 45 (1918 Act) provided that the bonus "shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion * * *". By Treasury Decision 3938, promulgated in 1926, (Internal Revenue Bulletin V-2, p. 117) the subdivision just

quoted was changed to read, as all regulations dealing with cost depletion have since read, " * * * there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property * * * which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received * * *". The same Treasury Decision made a similar change in Article 215 (a) of Regulations 62 (1921 Act) and Article 216 (a) of Regulations 65 (1924 Act). Article 216 (a) of Regulations 69 (1926 Act) was similar to the regulations under the prior Acts as amended by Treasury Decision 3938.[1]

All of the Regulations beginning with Regulations 45 under the 1918 Act have provided that if depletion is allowed with respect to an advance royalty and no oil or other mineral is produced by the lessee during the life of the lease, the lessor is required to restore the allowance to his accounts and to report it as income in the year the lease is terminated.[2]

The Regulations under the 1918 Act were questioned by the Board of Tax Appeals which held, in *Murphy Oil Co.*, 15 B. T. A. 1195, that, as a bonus bore no relationship to production, it could not be subject to a depletion deduction. The Circuit Court of Appeals for the Ninth Circuit reversed the Board, 55 F. (2d) 17, and this Court granted certiorari.

Before this Court passed on the Murphy case it disposed of *Burnet v. Harmel*, 287 U. S. 103, in which present counsel contended that a bonus received for executing an oil and gas lease in Texas was taxable as "capital gain" because, under Texas law, the leases conveyed fee title to the minerals in place. In disposing of the case this Court denied the taxpayer's contention largely on the ground that the bonuses involved were advance royalties subject to deple-

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(1) Article 215 (a) of Regulations 45 and Article 216 of the various Regulations, together with the change made by T. D. 3938, are set forth at page 4 of this brief.

(2) The applicable provisions of the Regulations are set forth at page 4 of this brief.

tion. There was no showing in the Harmel case that there was oil upon the property when it was leased or that production was obtained thereon in the same year or later.[1]

The Court in the Harmel case states (P. 111):

> "The Court below thought that the bonus payments, as distinguished from the royalties, should be treated as capital gain, apparently because it assumed that the statute authorizes a depletion allowance upon the royalties alone. See Ferguson v. Commissioner of Internal Revenue (C. C. A. 5th) 45 F. (2) 573, 577. But bonus payments to the lessor have been deemed to be subject to depletion allowances under Section 214(a) (9) Revenue Act of 1924, by Art. 216, Treasury Regulations 65, as well as under earlier acts. Section 214(a) (10), Revenue Act of 1921, Art. 215, Treasury Regulations 62. Cf. Murphy Oil Co. v. Burnet (C. C. A. 9th) 55 F. (2d) 17. The distinction, so far as we are advised, has not been taken in any other case * * *. We see no basis for it."

The Harmel decision was followed shortly thereafter by the decision in *Murphy Oil Co. v. Burnet,* 287 U. S. 299, wherein the question involved was (1) whether a substantial bonus, or advance royalty, paid to a lessor of oil land by his lessee was non-depletable income in its entirety when received, or (2) whether, by an allowance for depletion with respect thereto, the basic depletable value should be reduced, so that, in later years, the allowance for depletion on ordinary royalties, would be based upon such depletable value less the depletion allowable with respect to the advance royalty, instead of upon the full value, as would have been the case if no depletion had been allowable with respect to the advance royalty. This Court said (p. 302) that it was no longer open to doubt that:

> "* * * when the execution of an oil lease is followed by production of oil, the bonus and royalties paid to the

[1] In its brief filed in the Harmel case in this Court the Government argued, without qualification, that the lessor was entitled to depletion on the advance royalty, and therefore, the advance royalty should not be taxed as capital gain.

lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Section 234. See Burnet v. Harmel, *supra*. This is obvious where royalties alone are insufficient to return the capital investment. A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, *making no provision for a reasonably anticipated production of oil on the leased premises,* would deny the 'reasonable allowance for depletion' which the statute provides. * * * Doubts, if any, whether the statute authorizes depletion of bonus payments have been definitely set at rest by the repeated re-enactment, without substantial changes, of the provisions of Sec. 234(a)(9) since the promulgation of treasury regulations providing for such depletion. * * * In addition, provision is made by subdivisions (c) and (d) of the Regulations, as amended, for such necessary capital readjustments as may be occasioned by the termination, abandonment or expiration of the lease before all the oil is extracted."[1]

The rule was reiterated in *Palmer v. Bender,* 287 U. S. 551, wherein the Court stated "Thus we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties" (p. 557).

The Bureau of Internal Revenue apparently endeavoring to follow this Court's ruling in the Murphy case, on January 16, 1933, promulgated General Counsel's Memorandum 11384 (Internal Revenue Bulletin XII-1 Page 64) in which the possible situations which could arise were divided into four classifications as follows:

(1) No oil being produced when the bonus was received, but future production practically assured because of near-by wells and geological indications.

[1] In the *Murphy* case, the fact that oil was produced from the property during the year the bonus was collected and subsequent thereto was fortuitous, and this Court does not appear to have placed any weight on this fact. It seems clear that this Court's decision in the *Murphy* case would have been the same if the bonus or advance royalty had been collected the last moment of the tax year so that there could be no production, and, therefore, no actual depletion of oil reserves in that year.

(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

(4) Property has never become productive.

The ruling held that percentage depletion would be allowed in situations (1) and (2), but denied in situations (3) and (4).

The difficulties of administration of G.C.M. 11384 are immediately apparent. Taxpayers would be compelled to employ expensive experts to prove to the Government experts that when the leases were signed production was "practically assured" and disprove that there was "not more than a speculative prospect of future production." One of the reasons for the adoption, in the 1926 Act, of percentage depletion, in lieu of discovery depletion, was to simplify administration and avoid such battles of experts.

Furthermore the requirements of G. C. M. 11384 are discriminatory and unfair. Under it the deduction for depletion with respect to a bonus can be dependent upon the time of the year a lease is made, upon the time necessary to drill a well, or the diligence of the lessee.

Suppose that, at the beginning of 1926, adjoining farms, as to which the prospects for finding oil were substantially equal, were owned by Jones and Smith. Neither farm met the requirement of "production practically assured because of nearby wells and geological conditions." Early in the year Jones leased his farm and received $10,000 bonus. His lessee immediately moved on the property and, notwithstanding the opinion of geologists, secured production on December 31, 1926, which was within the calendar year.

Under the G. C. M. he is entitled to depletion, so paid tax on but $7,250 of the bonus.

Smith started negotiations for a lease on his farm at the same time as Jones, but due to some delay on account of his abstract, or the like, was unable to actually execute the lease until later in the year. His lessee was diligent, but, despite every effort, was unable to complete the well and secure production until January 1, 1927, which was in the year following the receipt of the bonus. Under the G. C. M. Smith is not entitled to any depletion on the bonus, so must pay tax on $10,000.

We submit that no one can find any support for such theory in the law, the Regulations or the decisions of the Courts.

The Board of Tax Appeals on April 26, 1933, decided the case of *Lizzie H. Glide,* 27 B. T. A. 1264 (now pending in the Ninth Circuit) in which the taxpayer contended she was entitled to depletion on a bonus. The Board admitted that bonuses were advance royalties, but held that, unless there was production within the same year as the bonuses were received, there could be no deduction for depletion. The decision mentioned G. C. M. 11384 but held that as the facts presented did not come within the conditions under which depletion would be allowed under the G. C. M. the Board would not pass on it. The dissenting opinion of Board Member Van Fossan, Lansdon and Leech concurring, in the Glide case, is printed in the appendix to this brief at page 31.

The majority opinion in the Glide case apparently denies the deduction because the statute allows depletion in the case of "oil and gas wells", and cites with approval I. T. 2384 (Internal Revenue Bulletin VI-2 page 22) which held:

> "It will be noted that the above quoted section of the law operates only in cases of oil and gas wells and that the allowance for depletion at the rate therein provided is expressly limited to the gross income from

> such property. Accordingly it must be concluded that the application of Article 216 (e) of Regulations 69 is dependent upon whether or not the lease in question is of an oil or gas well, and that Article 216 (e) of the regulation does not apply to leases covering property on which no well is in existence."

The phrase "in the case of oil and gas wells" in the 1926 Act is identical with that in all earlier acts under which the allowance was made on bonuses regardless of whether or not there was a well. No attempt was made, either in I. T. 2384, or in the Glide decision, to explain why the phrase meant one thing in the Acts of 1918, 1921 and 1924 and something else in the Act of 1926. Likewise no attempt is made to explain the fact that before, contemporaneously with, and after the issuance of the I. T. the Bureau continued to allow depletion based on cost or March 1, 1913, value, irrespective of a well.[1] This Court, however, settled the question. In *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459, it was contended that, because of the advent of percentage depletion, the phrase "in the case of oil and gas wells" meant something different from what it had meant in earlier Acts. At page 467 the Court states:

> "There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not and that depletion includes under the 1926 Act precisely what it included under the earlier acts."

On June 29, 1934, the Board decided the case of *J. T. Sneed, Jr.*, 30 B. T. A. Advance Sheet No. 171, wherein it appeared that in a year prior to the receipt of the bonuses a gas well had been drilled, but it did not produce commercially until later years because of lack of pipe line facilities.

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(1) The later ruling of the Bureau of Internal Revenue in G. C. M. 11384 had the effect of overruling I. T. 2384 because it permitted percentage depletion where there was no well on the property.

No wells were completed in the years the bonuses were received, but when the case was tried there were fifteen or twenty wells on the property. The Board found that when the bonuses were received production was practically assured and, therefore, the case came squarely within the provisions of G. C. M. 11384 which permitted a depletion deduction on account of the bonus payment. The Board, however, refused to follow the G. C. M. and held the lessor was not entitled to depletion on the bonus because of the absence of production, with two members dissenting "for the reasons so ably set forth by Judge Sibley" in the case at bar.

The Board's memorandum opinion in the case at bar merely found that the bonus payments were received in 1926 and that there was no production on the property until 1930. The case was disposed of on the authority of the *Lizzie H. Glide case,* 27 B. T. A. 1264 because there was "no production during the taxable year before us, nor was there at that time more than a speculative possibility of production."

If the opinions below are affirmed the present petitioners will never secure a depletion allowance on account of the advance royalties received in 1926, although their property is now producing commercially under the leases granted in that year. It is, of course, understood that the allowance for depletion based upon a percentage of income from the property can never be made as to the royalty collected in advance unless made in the year in which the advance royalty is collected. If the lessor had developed the property himself, or leased without advance royalty, but with a larger ordinary royalty, he would have been allowed depletion on all his royalties when received. The Court below denied the depletion allowance, which the taxpayer must have to place him on equal footing with others similarly situated, from a practical standpoint, solely because of the fortuitous circumstances that the oil was developed

by a lessee, who chose to begin operations in a later year, even though had development not been successful, and had no "actual depletion" occurred, the allowance would have been restored to income and taxed in the year this possibility materialized.[1] In order to secure the depletion allowance, Herring in this case, must look alone to the production of oil, but the allowance looks forward or backward to actual production.[2]

The controlling statute here expressly required the allowances for depletion to "be equitably apportioned between the lessor and lessee." (Sec. 214 (a) (9) Rev. Act of 1926.)

The allowance for depletion of the type here involved is predicated primarily upon income. The allowance is 27½% of the gross income, but not more than 50% of the net income, from the property each year. Considered with the Regulations heretofore quoted, it plainly appears that the allowance depends upon receipts more than actual exhaustion of oil or gas reserves, and that, if the allowance be not made as the receipts come in and are taxed, the Congressional intention of allowing, over the life of the property to every one having an economic interest in the property, 27½% of their respective gross incomes therefrom, cannot be carried out. On the other hand, if the allowance is made as royalties are received, any allowance not followed by actual depletion through production can be recovered and taxed by the terms of the Regulation heretofore quoted.

The majority below in the case at bar held that a lessor

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(1) Article 216 of Regulations 69 provides: "(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid."

(2) See Judge Sibley's dissenting opinion in this case, R. 42, and page 27 this brief.

was not entitled to the statutory allowance for depletion with respect to advance royalties unless oil or gas was actually produced from the property during the tax year in which the advance royalties or bonus was received:

> "The depletion charge permitted as a deduction from gross income in determining taxable income 'in the case of oil and gas wells' represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest. Helvering v. Falk, U. S. Sup. Ct., Jan. 15, 1934; U. S. v. Ludey, 274 U. S. 295, 302. No statutory provision which has come to our notice authorizes such a deduction to be based on an expectation, however well founded, that oil or gas remaining in place in land during the taxable year in question will be extracted in subsequent years. Depletion of oil or gas is a result of the production and sale thereof. Palmer v. Bender, 287 U. S. 551, 558." (R. 42.)

The majority opinion takes no notice of the fact that an allowance for "percentage" depletion can only be taken as to advance royalties in the year the royalties are taxed; and that in cases where "percentage" depletion is not applied, the allowance with respect to the bonus or advance royalty *will not* be made in any other year; and that, in neither case, can subsequent allowances be increased on account of the fact that no depletion was allowed on the advance royalty.[1] Nor does it refer to the fact that, if depletion is allowed with respect to an advance royalty, and no oil or other mineral is produced by the lessee during the life of the lease, the lessor is required to restore the allowance to his accounts and to report it as income in the year the lease is terminated.[2]

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[1] As pointed out earlier in this brief "percentage" depletion, first introduced in the 1926 Revenue Act, is unique in that the total allowances to be made over the life of the property are not limited to any particular cost or basis. Under the alternate system in the 1926 law, and the only one in earlier acts since 1918, when the total allowances equalled the basis or cost, no more was allowable. "Percentage" depletion allowances are unlimited in that respect. It is therefore impossible to make up for the denial of the allowance on a bonus in a later year.

[2] Regulations 69, Art. 216(a) *supra*.

The opinion of the majority below indicates a misunderstanding of the Murphy decision. After reciting that oil was extracted in 1919 and 1920 it cites the Murphy case as holding that "the depletion charge permitted as a deduction from gross income in determining taxable income 'in case of oil and gas wells' represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest" (R. 42). The fact is that the leases in the Murphy case were made in 1913 and the bonuses were all paid prior to 1919. The question was whether the bonuses should be considered in their entirety as income when received, or if they should be treated as advance royalties and be reduced by a depletion allowance, and thus reduce the basis for the depletion allowance on income from production in later years. This Court held that allowable depletion must be deducted from the bonus in the year the bonus was received and the depletable base reduced accordingly. In other words, the decision holds that a part of the depletion deduction allowable on account of 1919 and 1920 production must be taken in the years the bonuses were received, irrespective of the actual depletion in those years. This means that the 1919 and 1920 allowance was not, as the majority below states, in step with actual depletion, but was less than the actual depletion incurred in those years, because a portion of the allowance was properly attributable to the prior years in which the bonuses were paid.

As this brief repeatedly states the allowance permitted by the statute follows income and looks forward or backward to actual depletion, and such has always been, and now is, the practice. For instance, payment for "oil runs" is ordinarily made in the month following the run. In computing depletion the Bureau of Internal Revenue consistently holds that the depletion allowance for December of any year is not allowable in the year in which the actual depletion occurs but in the following year when the income from the oil is received.

A further illustration of the misconception of the problem by the majority below is the statement (R. 41) that "It was suggested in argument that, by reason of Petitioner's receipt in that year of the large sum in bonuses, depletion allowances made in that year probably would be more beneficial to Petitioner than such allowances made in later years were likely to be". As appears quite obvious nothing that is done with respect to the allowance in the year here involved will have any effect on subsequent years. In later years the allowance will be 27½ per cent of the income from the property in those years.

Petitioners' view that the majority opinion below is in conflict with the decisions of this Court heretofore mentioned is reinforced by the similar view of the minority below. Judge Sibley, in dissenting said:

> "Both (bonuses and ordinary royalties) are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. Burnet v. Harmel, 287 U. S. 103; Murphy Oil Company v. Burnet, 287 U. S. 299; Bankers Coal Co. v. Burnet, 287 U. S. 309, Palmer v. Bender, 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been that a *reasonable* allowance shall be made *according to the peculiar conditions in each case.* Construing it as to a bonus, it is said in Murphy Oil Company v. Burnet, *supra,* at page 307: 'Here an anticipated depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.*' * * * If the tax officer treats a bonus payment as income, he must deplete it 27½% under the command of the statute." (R. 45 and p. 27 this brief)

The question should be considered in the light of well-known practical facts. Among these are the following:

It is most unusual for an oil and gas lease to be made on a tract of land already producing. Such leases ordinarily are the means by which the landowner secures the exploration of his property for oil or gas, and its discovery, as well as its development and exploitation. It is the custom for "ordinary royalties" to be the same in any territory, regardless of differences in the prospect of securing oil or gas on various tracts. This difference is ordinarily adjusted in commercial transactions by the amount of the advance royalty or bonus. Cf. *Work v. Mosier,* 261 U. S. 352.

The Treasury Regulations which, from 1918 to 1926, have expressly provided for depletion with respect to bonuses or advance royalties (See Murphy Oil Company v. Burnet, *supra*) never made any distinction whatsoever because one property might be producing when leased and another undeveloped, or because production might be secured in the year the lease was made on one and not until later on another. But these practical facts must have been known to the authors of these Regulations.

It is equally well known that, in the case of most oil and gas leases (including those involved in this case), the lessor cannot control the time development is begun. It can ordinarily be delayed by the payment of nominal rentals during the entire primary term of the lease. Likewise, the length of time for drilling a well varies, because of depth and geological conditions, from a few days to several months.

It is difficult to believe that this Court will hold that past practice is to be disregarded and the regulation applied only in the most unusual case (*i. e.,* in the case of the leasing of a property already producing), when that limitation is not plainly expressed.

A regulation which would grant an allowance for depletion equal to 27½% of over $680,000. of advance royalties,

if one or two hundred barrels of oil, worth, perhaps, $100.00 or $200.00 had been produced in the year of leasing, and deny the allowance if no production is secured until the next year, is arbitrary and capricious. The same is true of a regulation which would grant the allowance if one lessor grants his lease early in his tax year so that a well can be, and is, completed within that year, but denies it to a neighbor similarly situated, who leases so late in the year that his equally diligent lessee cannot secure actual production until the next year.

A further illustration of the inconsistency of the holding below is shown by the following quotation from Judge Sibley's dissenting opinion, wherein he states (R. 44 and p. 27 this brief):

> "If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his receipt of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timber, he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil expected to be recovered by the lessee."

The Court is referred to the dissenting opinion below (R. 42 and p. 27 this brief), as well as the dissenting opinion in the Glide case (p. 31 this brief), for a more extended discussion of such inconsistencies.

Conclusion.

As the decisions of this Court have established that a deduction for depletion is allowable on advance royalties; as Treasury Regulations have, since 1918, consistently allowed the same deduction; as Congress has repeatedly reenacted the depletion sections in the same language and in the light of the Treasury Regulations mentioned, and, as the rule of the opinion below is discriminatory, unfair, and ignores the practical aspects of the problem, the decision below should be reversed.

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October 1934.

APPENDIX.

Dissenting Opinion of Judge Sibley in Herring Case.

"SIBLEY, Circuit Judge, Dissenting:

"The question is whether a percentage depletion is allowable on bonuses received in 1926 for oil and gas leases which are to endure so long as oil or gas is produced when no well was drilled and no oil produced under them during that year, although the oil and gas were present and were produced later. The Board of Tax Appeals denied the allowance because there was no well, and this court denies it because no oil was taken out. One of the pertinent provisions of the Revenue Act of 1926, 'In computing net income there shall be allowed a deduction . . . in the case of mines, oil and gas wells, and other mineral deposits and timber, a reasonable allowance for depletion and for depreciation of improvements according to the peculiar conditions in each case,' occurred in previous acts. The other provision: 'In case of oil and gas wells the allowance for depletion shall be 27½ percentum of the gross income from the property during the taxable year,' is new. Great difficulty was found under the former provision in estimating the content of an oil and gas reserve under the ground and in arriving at what proportion of it was represented by the operations of a particular taxable year, and also in fixing the value of the reserve under the rules relating to discovery value. To avoid these difficulties Congress in the new provision ignored both the size and the value of the reserve, assumed that the value of any production of oil or gas would on the average be 27½ per cent original capital investment not to be taxed, and the remaining 62½ per cent would be taxable income, and provided for its taxation in the year it was received. It is evident that the 27½ per cent deduction which the statute not only permits but commands must be made in the year that the income which measures it is re-

ceived and taxed, that it cannot be taken any subsequent year, and that it is entirely independent of actual depletion, being so named because it looks forward or backward to the exhaustion represented by the income received. The purpose and command of the provision is defeated by the decision in this case. The oil and gas were present to be produced, as was of course supposed when nearly a half-million dollars were paid in advance for them as bonuses, and as was proven when the wells were drilled. That the lessees by their own choice not to drill the first year should control the taxability of the lessor's bonuses, or that the depletion allowance on the entire bonuses should depend on the production in the taxable year of a few gallons of oil or a few feet of gas seems to me both unreasonable under the general provision for depletion and in contradiction of the special provision for the percentage deduction.

"It is true that depletion, like depreciation because of wear and tear and obsolescence, is based on the actual gradual loss of capital. The allowance for wear and tear and obsolescence is, however, always estimated and distributed over the useful life of the property considered, and does not depend on a demonstration of what actually happened to it in the particular taxable year. The allowance for them is a general offset against all income for the taxable year rather than a deduction from some particular item of income, because wear and tear and obsolescence, although a loss of capital, do not directly produce any particular income. Depletion also may sometimes be a mere loss, as when oil or gas runs to waste or standing timber dies and rots. But ordinarily depletion refers to a commercial use of part of a reserved store, as where ore or gas or oil is extracted for sale, or timber or ore or oil is manufactured into lumber or metal or gasoline and sold. In such cases the capital represented by the depletion is used directly to produce income and is converted into it.

According to *Eisner v. McComber,* 252 U. S. 189, only gain is taxable income under the Sixteenth Amendment where a conversion of property is involved. Congress is therefore merely staying on safe constitutional ground in providing for this percentage depletion against income received from oil and gas. If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his receipt of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timbers he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil expected to be recovered by the lessee. Both are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. *Burnet v. Harmel,* 287 U. S. 103; *Murphy Oil Co. v. Burnet,* 287 U. S. 299; *Bankers Coal Co. v. Burnet,* 287 U. S. 309; *Palmer v. Bender,* 287 U. S. 551. The income tax statutes have studiously en-

deavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been that a *reasonable* allowance shall be made *according to the peculiar conditions of each case.* Construing it as to a bonus, it is said in *Murphy Oil Co. v. Burnet, supra,* at page 307: 'Here an *anticipated* depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.* The allocation is permitted by statute.' This language is quite at variance with that of the court below quoted in the majority opinion. When this provision was first enacted in 1918, Regulation 45, Art. 215 (d), provided that on the expiration or abandonment of a lease *without the removal* of any or all of the mineral contemplated by the lease, there must be a return to capital account of so much of the *bonus* deducted from the recoverable capital as *exceeds actual depletion,* and that amount must be treated as income the year the lease was ended. This shows that it was understood that the bonus payment was considered depletable in advance of actual depletion and that if the contemplated depletion does not occur the correction is to be made at the end of the lease. The same Regulation has been continued ever since, as Congress has reenacted the same depletion provision, and it is referred to and its operation approved in *Murphy Oil Co. v. Burnet, supra,* at page 304, and again at page 306. The statutory words: 'In case of oil and gas wells' are directly connected with 'or other mineral deposits.' Wells as such were not in the mind of Congress as subjects of depletion, but the deposits of oil and gas and other minerals were in mind,

and as shown above, depletion of bonuses on leases was regularly allowed although in most cases, no doubt, actual production is not accomplished in the year the lease is made. When in the Act of 1926 Congress again used the expression, 'In case of oil and gas wells' in connection with the percentage depletion no narrower meaning is to be attributed to it. *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459. On the contrary, even more plainly the receipt of income and not the existence of a well or of production from it is made the generating cause of the depletion allowance. If the tax officer treats a bonus payment as income he must deplete it 27½ per cent under the command of the statute.

"In *Helvering v. Falk*, .. U. S. .., depletion under all the Acts through that of 1926 was under consideration and the cases were reviewed with this conclusion: 'Whatever may be said concerning the power of Congress to treat the entire proceeds of a mine as income, obviously the statute has not undertaken to do so. The plain purpose we think was to tax only that portion of the proceeds remaining after proper allowance for depletion. This allowance represents property consumed, is treated as if capital assets, and no tax is laid upon it. The statute must be so applied in practice as to carry out this purpose.' The judgment in the case at bar defeats the statutory purpose and by denying the allowance which the statute commands taxes that part of the money received which ought to be treated as if capital assets."

Dissenting Opinion in Lizzie H. Glide Case.

"VAN FOSSAN, dissenting: I find it necessary to dissent from the decision of the majority. In considering the

right of a taxpayer to depletion, I am unwilling to decide the question on any basis so highly technical and artificial as that employed in the prevailing opinion. Under the reasoning of the majority, the right to depletion depends on the existence of a well on the property. Obviously the production of the well, provided there be a well, need bear no relation to the amount of depletion. The law allows a flat percentage of income from the property (not from the well) as depletion. The Supreme Court has held that a bonus is income. Therefore if the bonus be paid and there happens to be a well in existence (however inconsequential the production) the taxpayer gets full statutory depletion. If there be no well, regardless of other conditions, the taxpayer gets no depletion. But assume a case where, as frequently happens, a bonus is paid in one year and there is no well completed until the next year. The taxpayer would get no depletion on account of the bonus (or advance royalties, as the Supreme Court has called them) because there was no well on the property though all surrounding property bore productive wells, nor would he get depletion of the bonus in the next year even if a producing well be completed, because the bonus was not income in that year. Variations of this illustration, emphasizing the absurdities of the situation, could easily be multiplied.

"I am unable to see any defensble basis for a distinction that would produce such an inequitable and illogical result. The prevailing opinion introduces a new concept into the theory of depletion and in many cases sets at naught the intention of Congress as interpreted by the decisions of the Supreme Court so far as depletion of bonuses is concerned. *Murphy Oil Co. v. Burnet,* 287 U. S. 299. The cited case clearly decides that a bonus is depletable and makes no suggestion that this right should be governed by

such a rule as laid down by the majority. The court clearly suggests the opposite:

> "A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for *a reasonably anticipated production of oil* on the leased premises would deny the 'reasonable allowance for depletion' which the statute provides. * * * (Italics supplied.)

"Moreover, I further find myself in disagreement with the majority opinion in the summary manner in which G.C.M. 11384 is disposed of. That the Commissioner is not now contending for such a rule as proposed by the majority is clear from this memorandum, which provides that depletion should be allowed if future production is practically assured because of nearby wells and geological indications. Whether this interpretation is too narrow it is not necessary to discuss, but certainly it is broad enough to cover the instant case. The facts show that oil was being produced in the same township and in the same oil field. This brings the petitioner squarely within the first of the four situations referred to in the memorandum. The prevailing opinion dismisses the matter on the basis of failure of proof.

"In my opinion the majority of the Board throughout this opinion have grasped at a shadow of diction and allowed the substance of the thought and intention of Congress and the Supreme Court to escape them.

"Lansdon and Leech agree with this dissent."

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IN THE

Supreme Court of the United States

OCTOBER TERM 1934.

Nos. 176 and 177.

WILLIAM E. HERRING AND EULA DAY HERRING,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

REPLY BRIEF FOR PETITIONERS.

Because of the possibility of confusion which may arise from certain statements in the Respondent's brief, Petitioners deem it advisable to file this reply brief.

Respondent places great reliance upon a strict construction of the phrase "in the case of oil and gas wells"

and contends that the Treasury has consistently construed the statute as not applying to leases covering properties on which no well is in existence. (Brief, pp. 6, 8) The Respondent's position is in error for the following reasons:

The identical phrase "in the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion * * * according to peculiar conditions in each case * * *" has appeared in all revenue acts, beginning with the Revenue Act of 1918. Under all acts from 1918 to date, with the exception of the position now taken with reference to percentage depletion, the Respondent consistently allowed depletion on bonuses, irrespective of the presence of a well. In the Harmel case, 287 U. S. 123 (No. 26 October Term 1932)* the Government argued, without reservation, that bonuses were subject to a depletion allowance and cited as authority Article 216 of Treasury Regulations 65, as amended by T. D. 3938, and *Murphy Oil Company v. Commissioner,* 287 U. S. 299, which was then pending in this Court. The identical article of the Regulations cited is in all prior regulations, beginning with Regulations 45 under the 1918 Act.

Likewise, the word "wells" means, in addition to the drill hole itself, the oil reserve in the ground. The statute involved herein provides for a depletion deduction from the income from the *property.* Discovery depletion provided for an allowance based upon the fair market value of the *property* under certain conditions. Article 220 (a) (3) of Regulations 45, and corresponding regulations under subsequent acts, held that the "property" is the "well." It further held that the well, in addition to the drill hole, included the surface necessary for the drilling and operation of the well and the mineral content of the sand, zone or reservoir from which the production is drawn.** This

*The applicable portion of the Government's argument in its brief in the Harmel case is printed in the appendix hereto at page 7.

**This Regulation is copied in full in the Appendix herein at page 7.

regulation was quoted with approval in *United States v. Dakota-Montana Oil Co.*, 288 U. S. 460, 465.

Early in its brief the Government contends that a well must be on the property in order to permit the depletion allowance on a bonus, but at page 17 does admit that this Court held, in the Harmel case, that bonus payments to the lessor have been deemed to be subject to depletion allowances. We again emphasize that there was no showing of production in the Harmel case. Indeed this Court stated at page 106: "Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee" and in the light thereof held, under Regulations similar to those here involved, that the lessor was entitled to the allowance on a bonus.

Respondent further argues that a depletion deduction can only be taken when there is production. (Brief, pp. 6, 11) The Department's regulations refute the correctness of this statement. Article 216 (b) of Regulations 69, set forth at page 21 of the Government's brief, specifically provide, with reference to advance minimum royalties, that the depletion deduction shall be taken in the year in which payment is received, and that when so taken can not be allowed in subsequent years when the mineral is actually extracted. As previously stated, the term "mineral property" includes oil and gas wells. If the statements in the Government's brief are correct, sub-divisions (b), (c) and (d) of Regulations 69 are absolutely meaningless insofar as they refer to bonuses, which are specifically mentioned therein.

It is admitted that in the Murphy case there was production on the date of the lease, but nowhere in the Court's opinion is this fact made a test to the right of a depletion allowance on a bonus. The Government argues (Brief, p. 12) that the Murphy case decided that a bonus *may* be subject to a depletion. We submit that the language of this Court specifically states that the depletion allowance *must* be made. The exact language of page 302 is "the bonus or

royalty paid to the lessor both involve at least some return of his capital investment of oil in the ground for which a depletion allowance must be made under section 234."

The Respondent also argues (Brief, p. 12) "That there is a marked difference between advance payment of royalties in anticipation of further production, which is the case when a bonus is paid to the lessor of a producing or proven tract, and a bonus paid for the privilege of prospecting for oil, when there is merely a speculative possibility of success." But he does not state what the difference is. If the allowance is on a percentage basis and in one case there is one barrel of oil extracted, and in another case none, what is the marked difference which allows the entire depletion in one case and denies it in another?

An effort is made to show that I. T. 2384 established a uniform administrative construction that a well must be on the property in order to get the deduction here sought. No effort is made to explain that the practice since 1918 has permitted depletion on a bonus, irrespective of a well, and that the Regulations based on cost depletion still remain as they have been since 1918, irrespective of production.

The Respondent suggests (Brief, p. 15) that Petitioner in later years may derive advantages if their 1926 income is not subject to a depletion allowance, because that allowance reduces the basis for determining gain or loss and thus, in the event of later sale, the profit would be reduced. The argument ignores the realities. The ranch here involved is used primarily for cattle raising. As in most instances, it has been owned for many years, so there is no cost or other basis allocable to the oil reserves, because the mineral deposits were not known to exist on the land at the time it was acquired. In addition the sale of royalties by the fee owner is the exception rather than the rule. The same answer applies to the argument that the Petitioner is entitled to cost depletion—there is no cost to be depleted. Under the specific provisions of discovery depletion, the lessor is entitled to a deduction based on discovery. Per-

centage depletion replaced discovery depletion and it must be assumed that it was not intended to take this deduction from the lessor.

The last argument of the Respondent (p. 20) is that Petitioner did no developing and took no risk; that discovery depletion was to benefit wildcatters, and therefore, lessors should not receive the allowance. Lessors may take a risk by granting leases to wildcatters. If they refrain from leasing until production is reached in the immediate vicinity of their property, they are naturally in a better position to negotiate for larger bonuses. In any event, Congress, in its effort to increase oil production, permitted discovery depletion and specifically provided that the allowance "shall be equitably apportioned between the lessor and lessee."

We submit that in view of the long established administrative practice; of legislative reenactment of the provisions covering "oil and gas wells" in the light of this administrative practice, and the soundness of the rule that advance royalties must be subject to a depletion allowance if income is to be properly reflected, that the decision below should be reversed.

The decision of the Board below shows (R. 13) "No oil was produced from the properties during the taxable year; indeed there was no production until 1930." The Circuit Court found (R. 38) "No wells were sunk on the leased land until 1930, during which four wells were sunk, with the result oil and gas were produced."

Under the view taken by the Board and the Circuit Court it was unnecessary to determine which leases produced and which did not. If petitioners prevail in this case, and the Court believes each lease should be considered separately, we readily admit that, in justice to the Government, the cases should be remanded to the Board with instructions to determine those facts. In that event, if depletion is allowed for 1926 on leases which did not produce, the amount of the allowance may be restored to income for the year of

the termination of the leases in accordance with the recapture provisions of the Regulations.

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November, 1934.

APPENDIX.

Excerpt from brief for Petitioner filed in this Court in Burnet v. Harmel, No. 26, October Term, 1932, page 7:

> "Apparently the court below was impelled to make the distinction because of a misconception which it entertained as to the scope of the depletion allowance. It assumed that a depletion allowance was not made to the lessor with respect to the bonus, while such an allowance was made with respect to the royalty, so that 'this part of his capital is protected and returned'. The assumption that no depletion allowance was permitted with respect to the bonus is clearly erroneous. See Article 216, Treasury Regulations 65, as amended by T. D. 3938, V-2 C. B. 117; *Murphy Oil Co. v. Commissioner,* now pending in this Court, No. 80, October Term, 1932.
>
> Nor is the distinction made below between a bonus and a royalty supported by the cases cited. In every case which has been found where the question was presented it has been held that a bonus does not differ from a royalty, but on the contrary, constitutes a part of the royalty which is paid in advance. * * *"

Later in discussing *Work v. Mosier,* 261 U. S. 352, the Government at page 9 in the brief stated:

> "We submit that this Court did not reach the conclusion that bonuses were advance royalties because of any peculiar provision of the statute involved, but because they constituted 'income from the use of the mineral resources of the land'."

Article 220 (a) (3) of Regulations 45 states:

> "The 'property' which may be valued after discovery is the 'well.' For the purposes of these sections the 'well' is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of the particular sand, zone, or reservoir (limestone, breccia, crevice, etc.) in which the discovery was made by the drilling, and from which the production is drawn, to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area as heretofore provided."

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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 176

WILLIAM E. HERRING, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

No. 177

EULA DAY HERRING, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 13–14) was a memorandum opinion, and not officially

reported. The opinions of the Circuit Court of Appeals (R. 37–46, 57–58) are reported in 70 F. (2d) 785 and 790.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on April 24, 1934. (R. 46, 58.) A petition for rehearing was denied June 8, 1934. (R. 53.) The petition for writs of certiorari was filed July 14, 1934. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Was the partnership of C. T. Herring and Son, in which the two petitioners held an interest, entitled to deduct from its income for the year 1926 the statutory allowance for depletion in connection with cash bonuses received for the execution of oil and gas leases, even though there was no oil or gas produced from the property until after the close of the taxable year?

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9:

> SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale

or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

(U.S.C.App., Title 26, Sec. 935.)

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 216. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * *

(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property.

STATEMENT

The facts of the case, as stipulated by the parties (R. 21–22) and as found by the Board of Tax Appeals (R. 13) may be summarized as follows:

The petitioners, who filed separate returns under the community property laws of the State of Texas, owned an interest, during the year 1926, in the partnership of C. T. Herrin and Son. The principal business of the partnership was cattle raising, and it owned several ranches in the vicinity of Amarillo, Texas. (R. 13, 21.) During the taxable year, it leased portions of its ranches to various individuals and corporations for the purpose of exploring for and producing oil and gas. (R. 21.) Under these leases, the partnership received, during the taxable year, bonuses aggregating $683,793.75. (R. 13, 22.) No oil development had been begun on any of the tracts at the date of leasing, and there was no oil well within three and one-half miles of the tract at that date. (R. 22.) No oil was produced from the properties during the tax-

able year, and there was no production whatsoever until 1930. (R. 13.) On the partnership return filed for the year 1926, depletion was taken of $188,043.28 against the bonus receipts, as representing the statutory allowance of 27½ per centum of the total amount received as bonuses during the taxable year. (R. 13, 22.)

This deduction was disallowed by the Commissioner, with the result that the petitioners' distributive share of the partnership's net income was increased, and a deficiency of $11,337.29 was determined against each of the petitioners. (R. 13–14.) The Board of Tax Appeals sustained the action of the Commissioner. (R. 14.) The Circuit Court of Appeals affirmed the decisions of the Board of Tax Appeals, Judge Sibley dissenting. (R. 46, 57.)

ARGUMENT

The statute permits a depletion deduction from gross income to account for the partial exhaustion of the mineral content of the land due to the production occurring within the taxable period during which the income was received. *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, 370.

The bonuses received by the partnership during 1926 in the instant case represented income to the petitioners for that year. *Burnet* v. *Harmel*, 287 U.S. 103. In seeking deductions for depletion in connection therewith, the burden was clearly upon the petitioners to show that they were entitled to

them. *Brown* v. *Helvering,* 291 U.S. 193, 199; *Reinecke* v. *Spalding,* 280 U.S. 227, 232.

Since it is stipulated that no oil was produced from the property during the taxable year (R. 22), the income received in the form of bonuses did not result from a reduction of the amount of oil contained, and consequently no deduction for depletion can be taken from the income. The actual exhaustion of oil content in later years must be deducted through depletion from the income received in those years. *Burnet* v. *Thompson Oil & Gas Co.,* 283 U.S. 301. Otherwise, the final determination of the tax necessarily would be postponed indefinitely in every case presenting this issue, until it was concluded whether the property would produce oil. Such a deferment is repugnant to the expressed intent of Congress, providing for the payment of tax on net income received during the preceding year.

The petitioners assert that the majority decision of the Circuit Court of Appeals is inconsistent with the decisions of this Court in the following cases (Br. 14): *Murphy Oil Co.* v. *Burnet,* 287 U.S. 299; *Burnet* v. *Harmel,* 287 U.S. 103; *Palmer* v. *Bender,* 287 U.S. 551; *Helvering* v. *Falk,* 291 U.S. 183.

Petitioners chiefly rely on *Murphy Oil Co.* v. *Burnet, supra.* From the opinion of the Circuit Court of Appeals in that case (55 F.(2d) 17 (C.C.A. 9th)), it is evident that there was oil production

from the properties during the years in which the bonus payments were made, which were prior to the taxable years, and that court expressly limited the depletion deduction to the actual amount of depletion sustained during the taxable years. This Court, in affirming that decision, did not propound any principle of which we are aware controverting our contention in the instant case.

The other three cases relied upon by the petitioners involved different questions from that in the instant case, and are manifestly not in point. In *Burnet* v. *Harmel, supra,* this Court said (p. 105):

> The only question presented here is whether the bonus payments to the respondent, after allowed deductions, if any, are "gain from the sale or exchange of capital assets" within the meaning of the taxing act.

It is true that this Court found that no distinction existed, as contended for, between a bonus and a royalty received by lessor and indicated that both were subject to depletion allowances. There is nothing in the opinion, however, to intimate that a depletion deduction should be allowed independent of and irrespective of actual production from the property. We are unable to determine from the record whether there was oil production from the property during the taxable years. That fact was not presented to the court and had no relation to the question at issue before it.

In *Palmer* v. *Bender, supra,* the petitioner, who was a member of two partnerships, sought to deduct depletion allowances in connection with bonus payments and royalties received by him through the partnerships. Both partnerships had conferred upon oil companies the rights which they possessed as lessees of certain properties in return for bonuses and royalties. The Commissioner contended that the depletion deductions were improper, since the transactions constituted assignments or sales of the leases, with no reversionary interests remaining in the partnerships. This Court held that the partnerships retained an economic interest in the oil in place, which was subject to depletion upon the production of the oil. Therefore, not only was the question involved in the case entirely different from that in the instant one, but this Court expressly found in its opinion (p. 553) that there was actual production on the properties during the taxable years involved. Obviously, then, that case does not support the petitioners' contention in the instant case.

The only remaining case cited by the petitioners in support of their contention is *Helvering* v. *Falk, supra.* That case presented the question as to whether the beneficiaries of a trust were entitled to deductions for depletion because of iron ore removed from the properties forming a part of the trust's corpus. Not only is the case, therefore, no authority for the petitioners, but also reference to

the findings of the Board of Tax Appeals (24 B.T.A. 299, 301), discloses substantial production of iron ore during each of the taxable years involved.

To sum up: In three of the cases cited by the petitioners, the record discloses actual production during the taxable years in question, whereas, in the instant case, it is stipulated that there was no production whatsoever. The fourth case, *Burnet* v. *Harmel, supra,* where the record fails to disclose whether there was production, is similar to the other three cases, in that the questions decided therein were manifestly different from the question here presented, and all four cases are, therefore, readily distinguishable. In fact, these cases tend to affirm the dependency of the depletion deduction upon the actual removal of the mineral content, as expressed in the statute itself.

With no production occurring in the instant case during the taxable year, and none until four years later, in 1930, we submit that the deduction for depletion claimed by the petitioners was not authorized by the statute or the regulations, and was, therefore, properly disallowed. *Burnet* v. *Thompson Oil & Gas Co., supra.*

CONCLUSION

It is submitted that the decision of the court below is in accordance with the law and the previous decisions of this Court. The decision is not in con-

flict with that of any other Circuit Court of Appeals. The petition should therefore be denied.

Respectfully submitted.

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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 176

WILLIAM E. HERRING, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

No. 177

EULA DAY HERRING, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 13) has not been officially reported. The opinion of the Circuit Court of Appeals (R. 37) is reported in 70 F. (2d) 785.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on April 24, 1934 (R. 46, 52). A petition for rehearing was denied June 8, 1934 (R. 47). The petition for writs of certiorari was filed July 14, 1934, and granted October 8, 1934. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether bonuses paid a landowner, upon the execution of leases permitting exploration for and extraction of oil and gas, are subject to the depletion allowance authorized by paragraph (2) of Section 204 (c) of the Revenue Act of 1926 when there had been no prior oil development on the leased lands, no wells were drilled or under construction during the taxable year, and there was then no practical assurance of future production.

STATUTE INVOLVED

Sections 204 (c) and 214 (a) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 14, 26–27, U. S. C. App., Title 26, Secs. 935, 955, provide in part as follows:

> SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a)[1] or (b)[1] for the purpose

[1] Section 204 (a) provides that the basis for determining the gain or loss from the sale or other disposition of prop-

of determining the gain or loss upon the sale or other disposition of such property, except that—

(1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reason-

---

erty acquired after February 28, 1913, shall be the cost of such property, with exceptions immaterial here. Section 204 (b) provides that the basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be the cost of such property (with exceptions immaterial here) or the fair market value of such property as of March 1, 1913, whichever is greater.

able allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

STATEMENT

The petitioners, who are husband and wife, filed separate income-tax returns for the year 1926 under the Texas community property laws. They hold a 50% interest in a partnership which owns several ranches near Amarillo, Texas. In 1926 the partnership, which was principally engaged in the business of cattle raising, leased portions of its ranches to various individuals and corporations for the purpose of exploring for and producing oil and gas. The partnership received in that year bonuses for these leases totaling $683,793.75. (R. 21–22.) Prior to the leases there had been no oil development on any of the tracts and the nearest oil well was three and one-half miles away (R. 22). The first wells drilled on the partnership land were drilled about 1930 (R. 24). The wells produced gas but not oil; in three there was a favorable or small "showing" of oil; the fourth "made * * * about eight to ten barrels of oil" (*ibid.*).

The partnership lands are in the Texas Panhandle, and Panhandle oil cannot, because of its sulphur and paraffin content, compete with East Texas oil (R. 26). The production in East Texas, or close to Tidewater, will be used before more wells are drilled in the Panhandle, and the East Texas production may last from 7 to 15 years (R. 26, 28). In December 1932, at the time of the hearing before the Board of Tax Appeals, there was no way in which an owner of a gas well in the Panhandle could dispose of his gas (R. 15, 27).

The lease shown in the record, which is typical of the other leases executed by the partnership, provides for the usual royalty of one-eighth of all oil and gas produced, and the lessee can preserve his rights under the lease without commencing any well if he pays a nominal annual rental (R. 22, 31–32). The lease is for a term of 5 years and as long thereafter as oil or gas is produced (R. 31).

The partnership in its 1926 return claimed a depletion deduction of $188,043.28, this amount representing 27½% of its bonus receipts (R. 22). The Commissioner disallowed this deduction, increased the taxable income of the petitioners by their pro rata part of the deduction, and found a tax deficiency of $11,337.29 as to each (R. 2, 10, 22). The Board of Tax Appeals sustained the action of the Commissioner and the Circuit Court of Appeals, one judge dissenting, affirmed the decision of the Board of Tax Appeals (R. 14, 46, 51).

By stipulation, only the record in the case of petitioner William E. Herring has been printed and the decision in that case is to be accepted as the decision in the case of the other petitioner (R. 2).

SUMMARY OF ARGUMENT

The Revenue Act of 1926 authorizes, "In the case of oil and gas wells", an allowance for depletion based upon income from the property. Petitioners are not within the quoted phrase unless "wells" is construed to include a mere grant of authority to drill a well. There is no ambiguity justifying departure from the ordinary meaning of the words used, and the Treasury has consistently construed the statute and the regulations thereunder as not applying to "leases covering properties on which no well is in existence."

The allowance is for "depletion." Depletion allowances have always been recognized as representing deductions allowed to compensate the taxpayer for a wastage or exhaustion of his assets. It therefore cannot be assumed that Congress intended to allow a depletion deduction on account of bonus payments received in a year when there was no production, no well in existence or under construction, and no other facts then existing sufficient to give practical assurance of future production. The character of items as income or as deduction is to be determined by the events of the taxable year.

The foregoing view is not in conflict with *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. There is a marked

difference between a bonus paid to the lessor of a producing or proven tract of land, when the bonus constitutes an advance payment of royalty in anticipation of future production, and a bonus paid for the privilege of executing a lease which in subtance grants the lessee a long-term option to prospect for oil, when it remains a mere speculative possibility whether or not there ever will be any actual depletion.

The Board of Tax Appeals has uniformly held that, under circumstances similar to those presented here, a bonus is not subject to the depletion allowance based upon income authorized by the 1926 Revenue Act. The Circuit Court of Appeals for the Eighth Circuit has reached the same conclusion.

This Court has held that a bonus *may* be subject to depletion. It has not previously had occasion to consider the limitations of the depletion deduction as applied to bonus payments.

If the statute authorizes a deduction whenever the facts existing during the tax year give practical assurance of future production, the decision below should nevertheless be affirmed. Petitioners have failed to establish the facts necessary to bring themselves within the statute so construed.

ARGUMENT

Section 214 (a) (9) of the Revenue Act of 1926 (*supra*, pp. 3–4) allows as a deduction in computing net income from mines, oil and gas wells, and other

natural deposits, a reasonable allowance for depletion, to be made under rules and regulations prescribed by the Commissioner of Internal Revenue.[2] The earlier Revenue Acts (1918, 1921, and 1924) provided that in the case of mines and oil and gas wells the depletion deduction might, under certain conditions be computed upon the basis of "discovery value" rather than cost or March 1, 1913, value.[3] Paragraph (1) of Section 204 (c) of the Revenue Act of 1926 (*supra,* p. 3) limited this allowance to "mines." Paragraph (2) added a new provision permitting a depletion deduction for oil and gas wells equal to 27½% of the gross income from the property during the taxable year, but not in excess of 50% of the net income from the property, with the safeguarding exception that in no case should the allowance be less than if computed without reference to this paragraph. The question presented for determination is whether paragraph (2) permits depletion of a bonus given for executing a lease when there has been no prior oil development on the lessor's land, no well is drilled or started during the year the bonus is received, and there is then no practical assurance of future production.

It should first be noted that the percentage depletion deduction is allowed, "In the case of oil

[2] Substantially the same provisions are found in Section 214 (a) (10) of the 1918 and 1921 Revenue Acts and in Section 214 (a) (9) of the 1924 Revenue Act.

[3] Section 214 (a) (10) of the 1918 and 1921 Revenue Acts and Section 204 (c) of the 1924 Revenue Act.

and gas *wells.*" Petitioners are not within this phrase unless the word "wells" is construed to include the mere grant of authority to drill wells. We submit that, since there is no ambiguity in the language of the statute, the word "wells" cannot properly be construed to mean "leases." For the purposes of this case it is unnecessary to decide whether paragraph (2) applies only where there is a producing well; or where there is a completed, but dry, well; or where there is a well in course of construction; or where there is a well upon the same tract, but not upon the land covered by the lease for which the bonus was received. None of these situations is presented here.

Article 216 (e) of Treasury Regulations 69 (*infra,* p. 22), which deals with the percentage depletion deduction authorized by paragraph (2), provides that the deduction there allowed may be taken by "the lessor of oil and gas wells." In 1927 the following important interpretation of Section 204 (c) (2) and Article 216 (e) was issued (I. T. 2384, VI–2 C. B. 22, Appendix, *infra,* p. 21).

> It will be noted that the above-quoted section of the law operates only in cases of oil and gas wells and that the allowance for depletion at the rate therein provided is expressly limited to the gross income from such property. Accordingly, it must be concluded that the application of article 216 (e) of Regulations 69 is dependent upon whether or not the lease in question is of an

> oil or gas well, and that article 216 (e) of the regulations does not apply to leases covering properties on which no well is in existence.

There appears to be no later published Treasury ruling or decision inconsistent with the above ruling, with the possible exception of G. C. M. 11384, XII–1 C. B. 64 (Appendix, *infra,* p. 21), issued in 1933, reinterpreting Section 204 (c) (2) in the light of *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. Since throughout this period both the law and the Treasury Regulations thereunder remained the same,[4] I. T. 2384 seems to establish a uniform administrative construction which, upon familiar principles, is entitled to great weight. The only portion of G. C. M. 11384 which may possibly be regarded as qualifying I. T. 2384 is the conclusion of the General Counsel that Section 204 (c) (2) permits depletion of a bonus received in a year when there was no oil production, provided future production was then "practically assured because of nearby wells and geological indications."

Section 204 (c) (2) not only limits the deduction there authorized to cases of oil and gas "wells";

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[4] Section 114 (b) (3) of the 1928 and 1932 Revenue Acts, Article 236 (d) of the Treasury Regulations 74, and Article 230 (d) of Treasury Regulations 77. The 1932 Revenue Act did not change the percentage depletion provisions applicable to lessors, but it added the provision that there shall be excluded from gross income subject to the 27½% deduction "an amount equal to any rents or royalties *paid* or *incurred* by the taxpayer in respect of the property" (italics ours).

it defines the deduction as an allowance for "depletion." Depletion allowances have always been recognized as representing deductions allowed to compensate the taxpayer for a wastage or exhaustion of his assets (*Helvering* v. *Falk,* 291 U. S. 183, 187–188, and cases cited). Where, as in this case, a bonus is received upon execution of a lease authorizing exploration for oil on land which is not part of a proven oil-producing tract and no steps are taken during the taxable year to bring the property into production, there is not only no depletion of the taxpayer's assets during the taxable year but it remains wholly speculative whether there ever will be such depletion. Income taxes are taxes for annual periods and, in the absence of clear indication to the contrary, the character of items as income or as deductions is to be determined by the events of the taxable year. *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, 306; *Brown* v. *Helvering,* 291 U. S. 193, 199–201. This principle reenforces the conclusion otherwise to be drawn from the face of the statute, that Section 204 (c) (2) does not authorize depletion of bonus receipts under the circumstances of this case.

The view which we urge, that a bonus cannot be regarded as within a depletion allowance unless the circumstances then existing demonstrate with reasonable certainty that there will be actual depletion, is not in conflict with the decision in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, *supra,* holding that the Revenue Act of 1918 authorizes depletion of

bonuses received by a lessor of producing property. There is a marked difference between advance payment of royalties in anticipation of further production, which is the case when a bonus is paid to the lessor of a producing or proven tract, and a bonus paid for the privilege of prospecting for oil, when there is merely a speculative possibility of success. In the former case the depletion allowance is not divorced, as it would be if permitted here, from actual depletion. The *Murphy* case decided only that a bonus *may* be subject to depletion. It did not consider or decide the question presented here, whether *every* bonus given for execution of a lease authorizing exploration for and extraction of oil is within a depletion deduction.

Petitioners (Brief, pp. 11–12, 20–21) stress the fact that the depletion deduction granted by Section 204 (c) (2) depends more upon the amount of income than upon the amount of production of oil and gas. They seem to conclude from this that the deduction is allowed irrespective of any showing of actual present or future depletion. That the substitution of percentage depletion for discovery depletion involved merely a change of basis and did not alter the preexisting conception of the theory of depletion is clear from the opinion in *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, where this Court said, p. 467:

> There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion, in-

> tended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not, and that depletion includes under the 1926 Act precisely what it included under the earlier Acts.

Accordingly we submit that there is no indication that Congress intended the allowance under the Revenue Act of 1926 to be made in a case where none would have been permitted under the prior Acts. Section 204 (c) (2) was adopted "in the interest of simplicity and certainty in administration" because of the difficulty of administering the provisions of the earlier acts permitting depletion of oil and gas wells based upon discovery value.[5] The very liberality of this deduction, which is not limited to wells where the taxpayer can establish discovery value, would seem to indicate that the words of the statute should not be extended beyond their natural meaning and that the deduction should be confined to cases where, during the taxable year, *some* present or future depletion can be demonstrated.

Petitioners also contend that Article 216 (d) of Treasury Regulation 69, and like regulations under earlier Acts, show that a bonus received in a year in which there is no production is subject to a depletion deduction. Paragraph (d) (*infra*, p. 22)

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[5] S. Rep. No. 52, 69th Cong., 1st Sess., pp. 17–18; H. Conf. Rep. No. 356, 69th Cong., 1st Sess., pp. 31–32.

provides that upon termination or abandonment of a lease without the removal of "any or all" of the mineral contemplated, the lessor shall return as income in that year his excess depletion previously allowable in respect of bonus and royalty payments over the actual depletion sustained.

Paragraph (d) is not inconsistent with the ruling in I. T. 2384 (*supra,* p. 9) that the depletion deduction allowed by Section 204 (c) (2) "in the case of oil and gas wells" makes a well a prerequisite to allowance of the deduction. The quoted phrase does not necessarily mean a producing well, and, if it does, petitioners are not entitled to the depletion allowance claimed in their 1926 return. Moreover, paragraph (d) deals with the ordinary depletion deduction based upon cost or March 1, 1913, value, and the novel form of depletion deduction based upon a percentage of income, introduced by Section 204 (c) (2) of the Revenue Act of 1926, may require a stricter construction. In addition, paragraph (d) is designed to protect the Government against possible loss of revenue, and the words "any or all" may have been inserted in an excess of caution to cover any possible contingency. We submit that these words do not affirmatively show that the Treasury interpreted the law as authorizing depletion of bonus payments when during the taxable year there was neither production upon the leased lands nor assurance of future production.

Petitioners further contend that the loss of the depletion allowance is a hardship because, if the

property eventually produces oil in commercial quantities, there will be no later opportunity to compensate them for the withholding of the allowance against the bonus. We desire to point out that, as against such immediate apparent hardship, petitioners in later years may derive advantages if their 1926 bonus income is not subject to a depletion allowance. The allowance of depletion reduces the basis for determining gain or loss.[6] *United States* v. *Ludey,* 274 U. S. 295. If no depletion is allowed against the bonus there will be no reduction of the basis, and a later disposition of the property by petitioners would result in the computation of gain or loss upon a basis more advantageous to them than if the allowance now claimed had been made.

Petitioners point out (Brief, p. 12) that under certain conditions there will be no allowance for actual exhaustion under the percentage depletion provision of the statute. However, in such cases an income deduction is permissible upon the basis of unit depletion, which is the method followed in applying Section 214 (a) (9) of the Revenue Act of 1926 and the similar provisions of later Acts.[7] This deduction is based upon cost, and every depletion allowance made reduces the balance of the cost to be returned in later years, thus diminishing

[6] Section 202 (b) (2), 1926 Revenue Act; Section 111 (b) (2), 1928 Revenue Act; Section 113 (b) (1) B, 1932 Revenue Act.

[7] Section 23 (l), 1928 Revenue Act; Section 23 (m), 1932 Revenue Act.

the depletable base.* *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, *supra*. It is therefore clear that the allowance in later years, under provisions corresponding to Section 214 (a) (9) of the 1926 Revenue Act, will be greater if depletion had not been allowed against the bonuses received in 1926.

In view of these considerations, there is no assurance that the withholding of a depletion allowance against the 1926 bonus payments will result in ultimate hardship to petitioners. Their claim of hardship is also predicated upon the assumption that there will be later substantial production and therefore depletion. We submit that this assumption rests upon a very uncertain foundation.

In the various cases coming before the Board of Tax Appeals subsequent to *Murphy Oil Co.* v. *Burnet, supra,* the Board has consistently held that, under circumstances similar to those presented here or more favorable to the taxpayer, a bonus is not subject to the depletion allowance authorized by Section 204 (c) (2). *Glide* v. *Commissioner,* 27 B. T. A. 1264; *Umsted* v. *Commissioner,* 28 B. T. A. 176; *Sneed* v. *Commissioner,* 30 B. T. A. 1121. The Circuit Court of Appeals for the Eighth Circuit, in affirming the *Umsted case, supra,* reached the same conclusion. *Umsted* v. *Commissioner,* 72 F. (2d) 328, 329.

While the general rule applicable to depletion of bonus payments has been before this Court several

* Article 216 (a), Treasury Regulations 69; Article 236 (a), Treasury Regulations 74; Article 230 (a), Treasury Regulations 77.

times, it has not heretofore had occasion to consider the limits of the rule.

Burnet v. *Harmel,* 287 U. S. 103, held that bonuses received by a landowner upon the execution of oil and gas leases were taxable as ordinary income under the Revenue Act of 1924, and not at the lower rate applicable to profits realized on the sale of capital assets. The Court, in reaching this conclusion, pointed out (p. 111) that "bonus payments to the lessor have been deemed to be subject to depletion allowances" under both the 1924 Revenue Act and earlier Acts.

Murphy Oil Co. v. *Burnet,* 287 U. S. 299, *supra,* held that, in computing the depletion deduction applicable to royalties received in 1919 and 1920 by a lessor of oil lands, the cost or March 1, 1913, value of its property should be adjusted for bonuses which it had received in prior years, since the statute and Treasury regulations (1) authorize depletion of bonus payments and (2) require an adjustment of cost or value of the property on account of depletion deductions so allowed. No question was or could have been raised as to whether or not the particular bonus payments received by the taxpayer were within the statutory allowance for depletion, because oil was being produced on its land in paying quantities before the lease in question was executed (*Murphy Oil Co.* v. *Burnet,* 55 F. (2d) 17, 19).

Palmer v. *Bender,* 287 U. S. 551, held that bonuses paid to a lessee upon execution of subleases

were subject to the depletion deduction authorized by the Revenue Act of 1921. It appears from the opinion of this Court (pp. 553–554) that there were producing wells on the property at the time the subleases were executed.

United States v. *Dakota Montana Oil Co.*, 288 U. S. 459, held that the capitalized cost of drilling oil wells is within the depletion deduction of 27½% of gross income authorized by Section 204 (c) (2) of the Revenue Act of 1926, and that therefore a corporation claiming a deduction under this section was not entitled to an additional deduction for depreciation of such capitalized cost under Section 234 (a) (8)[9] of that Act.

If this Court should adopt the view that Section 204 (c) (2) does not require a well on the lessor's land, either in existence or under construction during the tax year, but that the lessor is entitled to the deduction if the facts then existing give practical assurance of future production, the decision below should, nevertheless, be affirmed. Petitioners have failed to establish the facts necessary to bring themselves within the deduction so construed.

Petitioners received bonus payments in 1926 from 18 different lessees in consideration for the execution of at least 18 different leases (R. 21–22). The record shows that the first oil well in the Panhandle was brought into production in 1922 or

[9] This section grants corporations the same deduction allowed individuals by Section 214 (a) (9) of the Act (*supra*, pp. 3–4).

1923; that in the latter year a well was discovered about 4½ miles south of petitioners' land and another well about 3½ miles east of their land; that in 1926 the nearest well was 3½ miles away; and that the geological structure of their land is favorable to oil discovery (R. 22, 24, 27). This falls far short of establishing that in 1926 future production on any part of the land was practically assured. It falls even farther from establishing that future production on any particular lease or leases (of the 18 or more executed) was practically assured. One of petitioners' witnesses stated, "It is possible, but not probable, that there might never be any wells in the Herring property" (R. 27). The fact that until December 1932 (R. 15) only 4 wells had been drilled, involving 3 of the 18 lessees from whom bonuses had been received in 1926 (R. 21–22, 24), shows that, viewed in the light of subsequent events, future production on any particular lease or leases was not merely not practically assured; it was not even probable. The Board of Tax Appeals found that there was no production during 1926 and that there were not at that time "more than a speculative possibility of production" (R. 14).

Finally, it should be borne in mind that the rule for which we contend will ordinarily exclude only the initial bonus paid to the lessor of wildcat territory. While these petitioners received bonuses aggregating over $600,000, this total was received on account of at least 18 separate leases. The record does not disclose the bonus payments on a per-

acre basis and there is nothing to indicate that they were any greater than those usually paid the lessor of a wildcat lease. Congress had no reason to favor such lessors. They do no developing and take no risks. Discovery depletion was intended to benefit primarily the wildcatter or pioneer—the lessee of wildcat territory.[10] Discovery depletion was replaced by percentage depletion in the interest of simplicity. (*Supra,* p. 12.) It is true that, because of the statutory provision for equitably apportioning the depletion deduction between lessor and lessee, the former receives the advantage of the discovery basis, but this is wholly incidental to the primary purpose of encouraging and rewarding those who assume the risk.

CONCLUSION

It is respectfully submitted that the judgments of the court below should be affirmed.

J. CRAWFORD BIGGS,
Solicitor General.
WILLIAM STANLEY,
The Assistant to the Attorney General.
FRANK J. WIDEMAN,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
MILFORD S. ZIMMERMAN,
Special Assistants to the Attorney General.

NOVEMBER 1934.

[10] S. Rep. No. 617, 65th Cong., 3d Sess., p. 6; H. Rep. No. 1, 69th Cong., 1st Sess., p. 6.

APPENDIX

Article 216 of Treasury Regulations 69 (promulgated under the Revenue Act of 1926) provides:

> (a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.
>
> (b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall

be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property.

I. T. 2384, VI–2 Cumulative Bulletin 22, provides:

> The opinion of this office is requested concerning the following portion of article 216 of Regulations 69, relative to depletion deductions:
>
> "(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property."
>
> The question is raised as to whether, under the provisions above quoted, the lessor is entitled to a deduction for depletion of 27½ percent of any amount received as a bonus for oil and gas leases or of any amount received as oil or gas lease rentals.
>
> Section 204 (c) 2 of the Revenue Act of 1926, upon which article 216 (e) is based, provides that—
>
> "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."
>
> It will be noted that the above-quoted section of the law operates only in cases of oil and gas wells and that the allowance for depletion at the rate therein provided is expressly limited to the gross income from such property. Accordingly, it must be concluded that the application of article 216 (e)

of Regulations 69 is dependent upon whether or not the lease in question is of an oil or gas well, and that article 216 (e) of the regulations does not apply to leases covering properties on which no well is in existence.

G. C. M. 11384, XII–1 Cumulative Bulletin 64, provides:

> An opinion is requested relative to the application of the decision of the United States Supreme Court in the case of *Murphy Oil Co.* v. *Burnet,* December 5, 1932 (53 S. Ct. 161), to certain situations arising in connection with the allowance of percentage depletion in the case of a bonus paid for an oil or gas lease.
>
> Although the United States Supreme Court had before it in the *Murphy* case a question which arose in connection with an allowance for depletion based on cost, some of the language used by the court appears to be equally applicable to certain situations arising in connection with percentage depletion. The language referred to is as follows:
>
> "* * * when the execution of an oil and gas lease is *followed by production of oil,* the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under section 234. * * * A distinction between royalties and bonus * * * making no provision for a *reasonably anticipated production of oil* on the leased premises, would deny the 'reasonable allowance for depletion' which the statute provides. * * *"
>
> The four situations to which attention is called are as follows:
>
> (1) No oil being produced when the bonus was received, but future production practi-

cally assured because of nearby wells and geological indications.

(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

(4) Property has never become productive.

It is stated in substance that it is the opinion of the Income Tax Unit that a practical application of the law and the regulations in the light of language used in the *Murphy Oil Co.* case would be to allow depletion in situations (1) and (2) and to deny it in situations (3) and (4).

After consideration of the question, this office is of the opinion that the conclusion reached by the Unit is correct and should be applied in the disposition of future cases involving this issue.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

U. S. GOVERNMENT PRINTING OFFICE: 1934

SUPREME COURT OF THE UNITED STATES.

Nos. 176 and 177.—October Term, 1934.

William E. Herring, Petitioner, 176 *vs* Commissioner of Internal Revenue. Eula Day Herring, Petitioner, 177 *vs.* Commissioner of Internal Revenue.	On Writs of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[December 3, 1934.]

Mr. Justice Roberts delivered the opinion of the Court.

The petitioners are husband and wife and the income which gives rise to this controversy is derived from community property. We are to determine whether in computing net income under the Revenue Act of 1926 they were entitled to deduct from advance royalty or bonus received upon the execution of oil and gas leases the statutory percentage allowance for depletion, it appearing that there was no production when the leases were made, or at any time within the taxable year.

The petitioners' community estate held a half interest in a partnership whose principal business was cattle raising. The firm owned a tract near Amarillo, Texas. In 1926 it leased portions of this land for the purpose of mining and operating for oil and gas. In that year the lessees paid an aggregate of $683,793.75 as advance royalties or bonuses, and were obligated to pay additional royalties of one-eighth of the product or its value as oil and gas were extracted. The leases were for terms of five years and so long thereafter as oil and gas should be produced. When the instruments were executed there was no oil well within three and a half miles of the demised land. The lessors had no right to compel the drilling of wells and none were put down during 1926. In 1930 four were drilled which proved to be commercial gas wells, all made a showing of oil, and one produced from eight to ten barrels a day.

In their tax returns for 1926 the petitioners each claimed a pro rata share of a depletion allowance of $188,043.28, being 27½ per cent. of the bonus payments to the partnership. The Commissioner

disallowed the claim. The Board of Tax Appeals sustained his decision. The Circuit Court of Appeals affirmed the Board's action.[1] We granted certiorari.[2]

The pertinent sections of the Revenue Act of 1926 are 214 (a) (9) granting a reasonable deduction for depletion in the case of oil and gas wells, and 204 (c) (2) permitting computation of the allowance at 27½ per centum of the gross income from the property.[3]

A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income.[4] As such it is a part of the "gross income from the property" as the phrase is used in Section 204 (c) (2) to designate the base for the application of the percentage deduction. From these premises the petitioners argue that the bonus received does not lose its character as income subject to depletion, merely because it happens that in the year of receipt there was no production of the depletable asset.

The respondent replies that the allowance for depletion is a matter of grace, not of right, and that the act fails to grant any allowance on income such as that here involved. The argument is that in both the relevant sections of the act, the statute says "in the case of . . . oil and gas wells" and this expression necessarily excludes a case where no well exists. In support of this asserted statutory exclusion it is urged that a depletion allowance is essentially and exclusively reimbursement for wastage or exhaustion of assets, and Congress could not have meant to permit an allowance in any year in which there was no extraction of oil or gas, and no practical assurance of production in the future. We think these arguments cannot prevail to defeat the petitioners' right to the deduction.

Each of the Revenue Acts, 1916 to 1934 inclusive, has granted as a deduction from gross income a reasonable allowance for depletion "in the case of . . . oil and gas wells."[5] The regulations under the 1926 Act and its predecessors dealing with cost depletion

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[1] 70 F. (2d) 785.

[2] 293 U. S. —.

[3] 44 Stat. 9, 14, 26-27; U. S. C. App. Tit. 26, §§ 935, 955.

[4] *Burnet* v. *Harmel*, 287 U. S. 103; *Murphy Oil Co.* v. *Burnet*, *Id.* 299; *Bankers Coal Co.* v. *Burnet*, *Id.* 308.

[5] See *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Helvering* v. *Twin Bell Oil Syndicate*, No. 170, Oct. T. 1934, decided this day; R. A. 1932, § 23 (l) 47 Stat. 169, 181; R. A. 1934, § 23 (m) Session Laws, Part I, 680, 689.

treated bonus or advanced royalty as subject to depletion,[6] and these have been approved by reenactment of the statutory provision without alteration. That under the law and the regulations a lessor is entitled to a depletion allowance on bonus payments is settled by the decisions of this court.[7] It has never been held here that the existence of a well conditioned the right to depletion. Nor, until recently, has the Treasury so ruled. After the decision of the *Murphy Oil Co.* case, *supra*, there arose a doubt as to how the flat percentage allowance first permitted by the Act of 1926 should be applied to bonus payments. In answer to a request, the General Counsel of the Bureau of Internal Revenue rendered an opinion[8] in which he said:

"The four situations to which attention is called are as follows:

"(1) No oil being produced when the bonus was received, but future production practically assured because of nearby wells and geological indications.

"(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

"(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

"(4) Property has never become productive."

and held that depletion should be allowed in situations (1) and (2) and denied in situations (3) and (4).

In the present case the Board of Tax Appeals followed an earlier decision in which it had referred to portions of the General Counsel's opinion with disapproval, but found it unnecessary to decide whether it was sound.[9] In that case no well had been drilled on the leased property within the taxable year in which the bonus was paid, and the Board, saying that depletion could not be allowed except as an incident of actual production, refused the claimed percentage deduction. In a later case[10] where it appeared the whole of the petitioner's land was proved oil and gas territory and a gas well had been drilled in a prior year and shut in for lack of pipeline facilities, so that there was no actual production during the taxable year in which the bonus was received, the Board overruled

[6] *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 303.

[7] *Burnet* v. *Harmel*, *supra*; *Murphy Oil Co.* v. *Burnet*, *supra*; *Palmer* v. *Bender*, 287 U. S. 551.

[8] G. C. M. 11384, XII-1 Cumulative Bulletin 64.

[9] *Glide* v. *Commissioner*, 27 B. T. A. 1264. See also *Umsted* v. *Commissioner*, 28 B. T. A. 176, affirmed 72 F. (2d) 328.

[10] *Sneed* v. *Commissioner*, 30 B. T. A. 1121.

the taxpayer's claim for depletion, adhering to its position that production during the year was prerequisite to any allowance and refusing to follow General Counsel's opinion.

The situation presented by the administrative rulings is this: A bonus is not a receipt from a sale of a capital asset and may not be returned as such; it is income in the year received; if any depletion is to be allowed against the receipt, the allowance must be claimed for the year of receipt; it cannot be allowed in any later year;[11] if the taxpayer computes depletion upon the basis of cost or March 1, 1913 value he may deduct depletion from a bonus payment, irrespective of the sinking of a well or the production of any oil or gas;[12] if, however, he elects to avail himself of the alternative method of computing deduction at a per cent. of gross income, though the nature of the deduction is unchanged,[13] he may not have any unless there be production within the taxable year; if the production be but trifling he may take a full percentage deduction upon the entire bonus, however disproportionate the allowance to the actual extraction of oil during the year. To condition the allowance on actual production, however small, or the imminent probability of production, and to deal in refinements as to the degree of probability of future production is in many cases to deny any deduction where the taxpayer elects to compute it under 204 (c) (2) (flat percentage of gross income from the property) and permit it where he elects to compute it under 204 (c) (on the basis of cost). But the nature and the purpose of the allowance is the same in both cases, and we find neither statutory authority nor logical justification for withholding it in the one and granting it in the other; much less for making the decision turn upon the circumstance that no production is obtained within the year in which the bonus is paid.

As to income tax liability in the year of termination of the lease, on account of bonus paid at the execution of the lease, if no mineral has then been extracted, we express no opinion.

The judgments are

Reversed.

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[11]Compare *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 306.

[12]See the regulations cited in *Murphy Oil & Gas Co.* v. *Burnet, supra,* at p. 303.

[13]*Dakota-Montana Oil Co.* v. *United States, supra,* at p. 467.